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## TABLE OF CONTENTS



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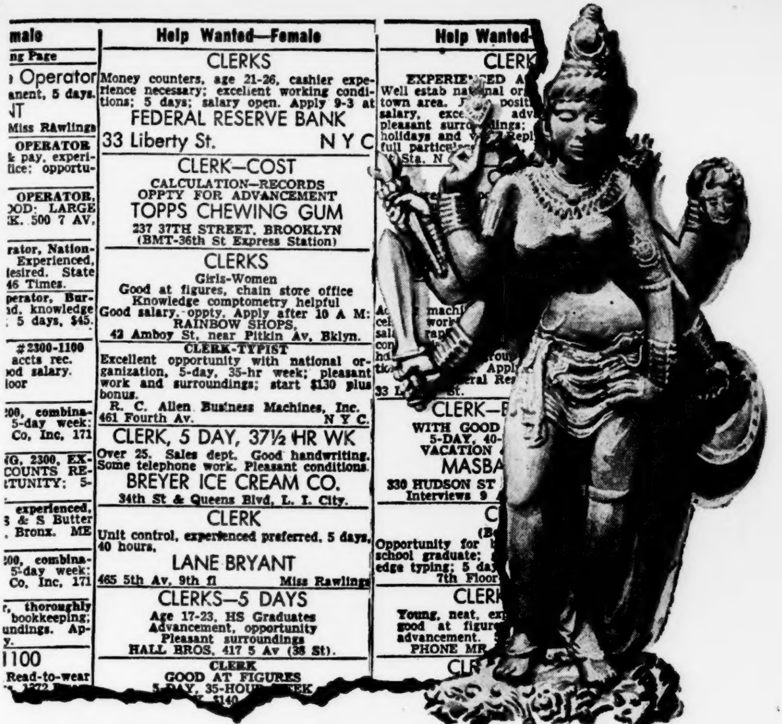


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# THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

*The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.*

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# What to Do When You Have A Fraud Case to Present for Your Client

*By* BORIS KOSTELANETZ, C.P.A.

SOME seven years ago I had an opportunity to address a small group of distinguished tax men at a downtown restaurant on the subject of income tax frauds and evasion. To my amazement, after the end of the talk I learned that, with but one or two exceptions, the members of that fairly representative group of tax men had never had anything to do with a tax fraud case. If that group were to gather together again today, I am quite sure that most of them would have had some intensive experience in this field, acquired since 1940. There is, of course, a good reason for this change.


BORIS KOSTELANETZ, C.P.A., has been a member of the Society since 1936. He was graduated from New York University, receiving the degree of B.C.S. in 1933 and the degree of B.S. in 1936, and from St. John's University School of Law with the degree of LL.B. (*magna cum laude*) in 1936. He is an Adjunct Professor in accounting and taxation at New York University Graduate School of Business Administration.

Mr. Kostelanetz, a member of the New York Bar, was formerly Special Assistant to the Attorney General of the United States in charge of the War Fraud Section, and Chairman of an Interdepartmental Committee on Tax Evasion and Black Markets. Previously he was an Assistant United States Attorney for the Southern District of New York. While in the Government he prosecuted a number of celebrated tax cases. He is presently engaged in the general practice of law as a member of a prominent law firm.

This paper was presented as one of the lectures in the federal tax series conducted by the Society's Committee on Federal Taxation.


When I first came to the United States Attorney's office in 1937, tax rates were relatively low and prosecutions were directed in a large measure against untaxpaid profits of illegal enterprises. The publicized criminal arm of the government in the field of tax evasion was principally felt then among gangsters, bootleggers, corrupt politicians, abortionists, and other illicit gentry. It is true that from time to time a business man was brought to book, but with a few exceptions, a suspended sentence or a thirty-day term received by a business man did not come to the public's notice and attention.

The war changed this. High taxes, currency transactions encouraged by black markets, and a possible looseness in business morality have created different problems in both the fiscal affairs of the government and in the administration of the penal sanctions of the

Revenue Code. Cheating the government in war years became distinctly unpopular. In the minds of millions of little and big honest taxpayers, who shouldered without question their share of the financial burden of supporting the government, such cheating was viewed as an effort by the evader to burden other citizens with the tax which the evader should properly pay. As a reflection of this change of attitude, in recent cases the courts have imposed upon business men substantial prison sentences, in some districts running up to five years. These business men were otherwise reputable; their unreported income was derived from lawful activities, and their sole anti-social conduct was that of income tax evasion.

I mention this background to make you appreciate that when a client comes to you with a fraud case, irrespective of its ultimate merits, you are in on the unpopular side of the argument.

It should also be noted that on the prosecution side of the ledger, the government's action is not limited to the taxpayer alone because criminal charges may include any person who attempts in any manner to evade any tax without regard to whether the particular person charged is under a duty to file the return. Thus, corporate officers and employees have been charged with attempting to evade and defeat the payment of a corporation's taxes. Accountants and bookkeepers have been included as co-defendants with taxpayers. All in all, tax evasion, once considered a fairly technical violation, has lost that character entirely and is now regarded as a serious crime.

In addition, you must also realize that even if there is no criminal charge, the civil consequences of tax frauds are frequently a matter of financial life or death because if the taxpayer is in a high bracket, a 50% fraud penalty often means complete financial ruin.

A criminal tax case begins when the Bureau of Internal Revenue gets information from someone that a taxpayer has not been paying the proper amount of tax. The information necessarily comes either from some member of the public or from a government investigator. Obvious sources of information are routine investigations by Internal Revenue Agents and Deputy Collectors. When they arrive at a suspicion of fraud, it is their duty to communicate immediately with the local office of the Intelligence Unit of the Bureau of Internal Revenue. Other sources of information are active reviews by government agents of government and commercial records. For instance, the contents of government files dealing with OPA violations, records of check cashing concerns, records of purchases of expensive items with currency all contribute to the Bureau's total information concerning possible frauds. In addition, the Bureau is in constant receipt of tips from informers who make their complaints anonymously or who identify themselves. The informers are business associates, social competitors, disgruntled employees, unhappy wives, informers who seek a reward, and even some informers who are concerned solely with law observance. These tips and leads have poured into the Treasury Department at the rate of about 40,000 per year.

In attempting to cover my subject, I find it impossible to discuss with you certain basic topics, such as tax avoidance as distinguished from evasion, details of administrative procedure in tax evasion cases, civil and criminal penalties applicable to tax frauds, etc. Most of these topics are already known to you, and in any event, are fully available in tax services and in a number of excellent magazine articles which have appeared during the past two years. My text tonight is limited to what you are to do in the light of established law and procedures when a client comes to you with a fraud case.

Unlike investigations of other violations, it is almost impossible for a taxpayer not to be aware of the fact that he is being investigated, and I

shall assume for the purposes of this discussion that on learning of an investigation the taxpayer for the first time approaches an accountant for advice as to what he should do. In many respects, decisions of this early period of an investigation can predetermine its ultimate course. The wisdom or the unwisdom of the decisions made at this time will ordinarily be reflected in developments which occur many months or even years later.

To repeat, our topic is "What to do when you have a fraud case to present for your client." The topic is a bit equivocal since you cannot readily tell whether the "client" referred to was your client at the time of the happenings of the alleged frauds. If that be the case, the accountant, to whom are revealed irregularities in tax matters which occurred during the period of his engagement—and, of course, which irregularities were unknown to him—should seriously consider stepping out or, by way of minimum precaution, he should consider bringing other counsel into the picture. The reasons are apparent: He himself may be suspected of complicity by the Bureau, conflicts of interest between accountant and client may develop, and occassionally an unscrupulous client may make unwarranted charges that he has been misguided by the accountant.

Assuming that a client, who has not been your client during the period of alleged irregularities, comes to you for advice in the case, I must say with all the emphasis possible, and with apologies to the *Bercu* controversy, in which I am neutral, by all means get a lawyer to associate with you in representing the client.

There are several reasons for my emphasis. The most obvious reason is that the client is immediately beset with problems which relate to the Fourth and Fifth Amendments of the Constitution. The amendments deal with fundamental legal rights and privileges, such as the right to be secure against unreasonable searches and seizures and the privilege against self-incrimination. These rights, while clearly worded in the Constitution, have been the subject of difficult and complicated interpretations by the courts. Judges and lawyers make no claim to knowing all the answers to all the propositions which may arise in this branch of constitutional law. Accordingly, you, as accountants, must not advise your clients in it. Another, and a most practical reason for the presence of counsel, is the immediate problem of getting the client to tell you the truth concerning the facts. When a client tells the facts to an accountant, it is not a privileged communication and an accountant may be forced to testify concerning what a client revealed to him. Statements made to a lawyer, however, for reasons of public policy, which go back to ancient times, are absolutely privileged, and such confidences are inviolate and secure forever unless later revealed by or at the instance of the client. Clients are, therefore, more apt to rely on the absolute privilege in telling their lawyer the truth.

The first step is to sit down with your client, subject to my views concerning counsel, and get him to tell you everything he knows. In so far as it is possible, the client should be made to substantiate everything that he tells you. Get the details minutely. It is normal and natural for clients who seek your services to tell you at the outset only their side of the story and they will conceal facts or circumstances unfavorable to them until some later period when you are well in the case. There are very few things in a case which can do you as much harm as a situation to which many of us have been exposed, where either in a conference or in a trial it is revealed that in addition to other things your client bought say $50,000 worth of Treasury bonds with currency. Your client will say, when questioned by you, that he just happened to forget that incident. That kind of thing just isn't good for you, nor is it good for your client.

The point of all this is that the taxpayer's representatives must be as well and even better informed than the government concerning the taxpayer's affairs. After all, there is an advantage in being on the taxpayer's side. The taxpayer should know all the facts. The government agents have to work from an outer periphery of information to get to the core, and this is very much more difficult.

The first decision upon the revelation of a fraud must be made quickly. That decision answers the obvious question: Is there still time to make a voluntary disclosure and how is such a disclosure to be made? The topic of voluntary disclosure deserves digression in our discussion and may well be considered at this time.

Once upon a time a voluntary disclosure had fairly well defined boundaries. For instance, generally:

1. A disclosure had to be voluntary and made before an investigation had been initiated;
2. It had to be a complete disclosure;
3. The taxpayer had to cooperate with the government in the subsequent investigation; and
4. He had to be willing to pay the tax and penalties.

With that kind of a record, a voluntary disclosure in due course was investigated and, together with all the pertinent facts concerning the tax liability, the taxpayer's file was eventually closed without prosecution. Certain statements of Chief Justice Vinson, the then Secretary of the Treasury, and particularly statements contained in an address made by former Chief Counsel J. P. Wenchel of the Bureau of Internal Revenue at a meeting in this city on May 14, 1947, have changed this picture. It is very likely that the change was brought about by the then too strict interpretation of the voluntary disclosure doctrine in that in former days any information, activated or not, contained in the files of the Bureau was regarded as the beginning of an investigation. Accordingly, disclosures were then frequently considered involuntary.

In his talk last May, former Chief Counsel J. P. Wenchel defined a voluntary disclosure as follows:

"A voluntary disclosure occurs when a taxpayer of his own free will and accord, and before any investigation is initiated, discloses fraud upon the government."

Then Mr. Wenchel stated how the disclosure is to be made. He said,

"The making of a voluntary disclosure is a simple thing. The taxpayer or his legal agent can go before any official of the Bureau of Internal Revenue or any of its field offices—whether it is the Collector, a Deputy Collector, a Revenue Agent, a Special Agent, or any other responsible Treasury officer. There is no special form for making the disclosure. The simple statement that 'I have filed false tax returns and I want to make the government whole,' would constitute a complete disclosure. Of course, it is usually best to present an amended return or other written document as evidence of the disclosure. If possible, the disclosure should be accompanied by payment of the tax which is known to be due, but this is not a prerequisite."

Under the prescriptions contained in this address, the Bureau had taken a position which on its face is most liberal to the taxpayers as to the method and manner of making the disclosure. Particularly, you will notice that there is no mention of the other three of the former four prerequisites, namely:

1. Full and complete disclosure;
2. Offer to cooperate;
3. Willingness to pay the entire amount of tax due.

And yet in almost the same breath, as we shall see, the Bureau limits severely its definition of when is an investigation initiated. The statement reads:

"Now we have said that in order to be considered voluntary, a disclosure must be made before we have initiated an investigation in the case. Therefore, it is essential that we define 'the initiation of an investigation.'

"The mere record of a name does not mean that an investigation has been initiated. The fact is that examining officers throughout the country have thousands of names or possible leads. To deny the existence of a voluntary disclosure merely because we have a name, would be comparable to regarding the telephone book as a dossier of tax evaders.

"An investigation is initiated when a Special Agent, an Internal Revenue Agent, a Deputy Collector, or other Bureau officer,

is assigned a return for examination, or where an investigating officer has requested advice of appropriate officers of the Bureau with respect to the filing of a return or the payment of taxes."

Speaking only for myself, I am of the opinion that despite the unquestioned good motives of a very wise Chief Counsel, his definition of the initiation of an investigation has not served to simplify or clarify the previous uncertainties which vexed the practitioner. If the Bureau has opened the door as to the manner of making the disclosure, it has seemingly closed that same door by effectively prohibiting a voluntary disclosure at a time when an agent is making an examination and the bona fideness of the return is not in issue. It has effectively prohibited a voluntary disclosure when a return has been assigned to an agent for an examination where it is merely resting in his file. In greater New York about 1,000 Revenue Agents, I am informed, have an average case load of fifty cases. Deputy Collectors have many more cases in their files. Conceivably, as many as 50,000 persons in New York are not in a position to make voluntary disclosures during a period when the return is checked out to an agent for investigation. No matter how desirous your taxpayer may be to make a voluntary disclosure, his willingness has to be frozen or tolled until such time as the agents get off his premises, file their report, and close his case. It is my view that this interpretation is much too narrow and cannot be reconciled with the fiscal policies of the government which make the voluntary disclosure doctrine desirable in the first place.

In addition, there are "twilight cases" which involve what the Bureau would call an "activated lead." This usually comes about by an agent making a collateral check of individuals other than the taxpayer and finding some evidence of fraud. Before the agent has had an opportunity to request the return, the individual checked resolves to make a voluntary disclosure. While I do not believe an agreement on this procedure has as yet been reached, the informal present consensus seems to be that his efforts do not constitute a voluntary disclosure.

There is one part of Mr. Wenchel's speech with which I think all of us are in complete agreement. He said,

"The time of disclosure and the time an investigation begins are, therefore, matters which can be ascertained with complete objectivity and certainty, thus protecting both the government and the taxpayer from decisions based on guesswork or other vague circumstances. To assure adherence to this principle, the Bureau stands ready at all times where a dispute may arise as to the time of a disclosure and the time an investigation was initiated to open its records in that regard."

It cannot be said that the present posture of the voluntary disclosure policy is satisfactory. It has created difficult working problems, both for the Treasury and for the practitioner, and it is difficult to see what will happen next. However, since taxpayers and practitioners do not make up Treasury policies, the next step is necessarily up to the Treasury.

And before I leave this topic, may I stress with all emphasis possible—to transpose the signs in your theatres—if a voluntary disclosure is in order, "Run, don't walk," to the nearest office of the Treasury Department. Voluntary disclosures may sometimes be a matter of minutes. State the time of the day to the official who first hears you. Note it in your files. You may be sure he will do the same in his.

Let us assume that voluntary disclosure is not applicable to your facts or that an attempt to make such a disclosure is unsuccessful. Again the solution to the next problem in the early stage of the investigation may well determine the final decision as to prosecution. The problem will come up this way. It is almost inevitable that a taxpayer will be invited to produce his books and to explain items which are alleged to be fraudulent. A critical decision will then have to be made as to his stand.

Under our form of government, save for corporate defendants, one who is accused of crime is not required to furnish evidence against himself.

The answer to the problem depends upon three groups of factual possibilities and you must determine by the facts in which group your client belongs.

*First*, assume the state of facts where the taxpayer is clearly innocent of any fraud. Then advise him by all means that he must cooperate to the fullest extent with the investigation.

*Second*, assume that you have a taxpayer who is confessedly guilty beyond all doubt, then you have a more difficult problem. There is no necessity for cooperation on the part of that type of client unless the client resolves in his own mind that he is so clearly guilty that he may as well, by way of mitigation, leave a trail of cooperation rather than one of controversy with the Bureau. It is hardly the function of a taxpayer's counsel to dissuade the individual who falls into this group from voluntarily making admissions against himself. It is, however, the clear duty of counsel to advise the taxpayer of all his rights, to see to it that the client understands those right before any irrevocable steps are made.

*Third*, assume that you have the most frequent of the three groups of cases, the case where the distinctions are narrow, where it appears that your client may be somewhat right and somewhat wrong. It is on this state of facts that no general answer can be given. The constitutional privilege against self-incrimination may be waived before indictment or trial, and a decision to waive the privilege must be an informed decision. The decision just cannot be made haphazardly and certainly it cannot be the result of inadvertence. There are, of course, close cases when full cooperation with the government's agents should tip the scales in favor of of a decision by the government not to prosecute. There are cases when cooperation in and of itself may place you in a position where you can bargain effectively for your client. In other, and perhaps infrequent situations, there are cases where taxpayers have helped to make fraud cases against themselves by their own admissions where otherwise successful prosecution would have been difficult if not impossible. Each case really has to be decided on its own facts and it is unfortunate that the decision is frequently made doubly difficult by the reluctance of the taxpayer in the early stages of an investigation to supply all the facts.

Parenthetically, I do not mean to imply in any sense that in what I called border-line cases the taxpayer is necessarily guilty of tax evasion. Revenue men, as well as tax practitioners, are sometimes fallible in their estimate of a case. And I believe it to be a fact that many business men who have bought and sold merchandise in the black market, without thoughts of cheating the revenue, are now suspiciously entangled in a web of currency transactions and in a chain of events which circumstantially point to tax evasion.

After you have received your preliminary facts from your client, the next step requires you to do exactly what the government's investigators do in working up their case—and a little more. If they are relying on bank deposits which are unrecorded in the general books of account for their case, you too must go to the banks and get deposit tickets and recordak records to conduct your study. If they are questioning legitimacy of deductions, you must not only go over the same ground but in addition, you must check to see if the taxpayer has failed to claim deductions sufficiently substantial as to leave an inference that the irregularities in the return are attributable to ignorance rather than fraud. It is useless to enumerate all the possible techniques. They depend entirely on the circumstances of each case, and while some cases tend to run to a pattern, each case is sufficiently individual to require the greatest amount of concentrated accounting skill.

The work of the accountant in this phase of the investigation is difficult and tedious. Without it, however, it is most improbable that extemporaneous resources alone at a conference or at a trial would ever help your client.

Assuming that the Special Agent recommends prosecution, the case starts a circuitous route. His recommendation is reviewed at least a half a dozen times; first, by the Special Agent in charge of his office, then by the Regional Office of the Penal Division of the Chief Counsel's Office (where there is a Regional Office, and in New York we have one at 253 Broadway), then by an attorney in the Penal Division in Washington, then by the head of the Penal Division, the Chief Counsel and even by the Commissioner of Internal Revenue. If the recommendation for prosecution is approved all along the line, the file is forwarded to the Tax Division of the Department of Justice in Washington, and it is again reviewed, appraised and reanalyzed, and if a decision is made to prosecute, the case is referred to the appropriate United States Attorney. If he concurs, the case is then presented to the grand jury. If the grand jury votes an indictment, the taxpayer, who has now become a defendant, either pleads guilty or stands trial.

At practically all the stages through which the case passes, conferences are freely given to taxpayers and to their representatives. While some of the conferences, particularly those in the Penal Division, may seem to be somewhat unilateral in that the taxpayer's representatives do the talking, while the government attorneys do the listening, it is not true that each stage is merely a rubber stamp for the prior one. It is a fact that a large percentage of cases are rejected for prosecution at each level, and the lawyer and the accountant who have proper defenses owe a positive duty to their client to present the merits of the defenses before each and every office which gives consideration to the matter.

In this connection, when you come to the actual defense of a man charged with crime, the problem is essentially legal. The lawyer in the case must necessarily become the predominant defense personality and the accountant has to take the secondary role in the preparation of the case. Whatever the public or possibly certain practitioners abstractly think of defending criminal cases, it is important for the lawyer and for his associates to get into a frame of mind which permits no doubts of their duties and responsibilities. The pertinent canon of the Canons of Ethics of the American Bar Association states:

> "It is the right of the lawyer to undertake the defense of a person accused of crime, regardless of his personal opinion as to the guilt of the accused; otherwise innocent persons, victims only of suspicious circumstances, might be denied proper defense. Having undertaken such defense, the lawyer is bound, by all fair and honorable means, to present every defense that the law of the land permits, to the end that no person may be deprived of life or liberty, but by due process of law."

Accordingly, you must appreciate that under our system of law, the defendant has an absolute right to be represented by counsel who is on his side just as the prosecution has a right to be represented by an attorney who is on its side.

Secondly, your personal opinion, or that of other lawyers, has nothing whatever to do with the charge. If it did, defendants would be tried by lawyers. Under our process of law, based upon the wisdom of experience, persons accused of crime are tried by courts and juries and not by lawyers and, again, due process includes a lawyer on the side of the accused.

Thirdly, you must see to it that the law is complied with and that you must by all fair and honorable means present every defense that the law permits.

I must most earnestly stress the vigor with which you must proceed in criminal fraud cases. As a rule, in civil disputes someone becomes richer or

poorer, and that's about all. In criminal fraud cases, it can happen that someone may go to jail solely because proper attention has not been given to his affairs. If cooperation is appropriate, provide utmost cooperation; cater to every wish and whim of government investigators. If constitutional rights are to be exercised, be firm and polite in explaining to the agents your position, without necessarily making the case a "challenge" to the agents. If a contest is indicated, you must lay aside even the affairs of good paying clients because the responsibility to an individual who regards you and his lawyer as the only thing standing between him and jail is greater than the responsibility to one concerned solely with making a little more or a little less money.

In conclusion, the defense of a fraud case is a worrisome, difficult matter. Again, unlike civil disputes, you are bound to carry the problems of your client with you when you leave your office. You will worry about them at home. It takes the strongest of minds and perhaps the most calloused of consciences not to suffer to some extent with your client on each and every adverse ruling. On the other hand, you are not dealing with cold mathematical abstractions. You are dealing with human beings, their joys and their sorrows, their successes and their frailties. It is an interesting field and as such I commend it to you.

## WHAT DOES AN AUDITOR'S "CERTIFICATE" MEAN?

Balance-sheets and income statements submitted as a basis for credit, or in reports to stockholders, are commonly audited by independent certified public accountants. The "certificate" or report of the accountants precedes or follows the financial statements. It tells briefly what the auditor did and gives his opinion as to whether the financial statements fairly present the financial position and results of operations of the concern for the period under review.

* * *

The certified public accountant's opinion is far from being merely a wild guess. It is the opinion

a) of an expert in accounting and auditing, who
b) is independent of the management, and
c) is professionally responsible for what he says.

This opinion

d) is based on adequate examination of the facts, and
e) is a report on the concern's use of generally accepted accounting principles, consistently maintained.

—Excerpts from the pamphlet issued by the American Institute of Accountants for persons relying on the information in financial statements.

# The Taxation of Transactions in Foreign Currencies

*By* Sidney I. Roberts, C.P.A.

THE economic, political and social forces which have thrust this country into its important rôle in world affairs, demand that we accountants, too, enlarge our horizons to international scope.

Accelerated transportation of men and materials, which serve to reduce the barriers of space and time; contacts made by servicemen with foreign countries and awarenesses they may have gained of opportunities therein; the far-flung disposition of our merchandise and manufactured products throughout the world; the necessity for reconstruction of devastated areas and the need of American capital for that purpose; the efforts of our government to reduce the import barriers; all will tend to stimulate travel, business and investment abroad, bringing for solution under the federal income tax law new problems resulting from transactions involving foreign currencies. To this add the relocation of displaced persons in this country (many of whom retain interests in their country of origin), the governmental management of currencies, and the fluctuation in value of foreign currencies, resulting from the war and its aftermath. It then takes no seer to predict that multi-currency transactions will assume an expanding importance for the accountant.

Sidney I. Roberts, C.P.A., is a member of our Society and of its Committee on State Taxation. Graduated from the College of the City of New York with a B.B.A. degree, he went on to the Harvard Law School, which awarded him the degree of LL.B., *magna cum laude,* and membership on the Harvard Law Review. Upon his return from the U. S. Army, he resumed active practice with a prominent firm of C.P.A.'s.

This paper is an abridgement of a lecture delivered by Mr. Roberts on December 9, 1947, for the 1947-48 Federal Tax Lecture Series presented by the Committee on Federal Taxation of our Society.

Less and less unfamiliar will be the situation of a client buying and selling goods abroad; investing, lending and borrowing in foreign countries; or operating branches or subsidiaries there. This development of foreign trade and investments will necessarily increase the number and importance of transactions involving foreign currencies.

In the interests of our clients, it is incumbent upon us to be aware of the uncertainties, pitfalls and possible advantages in the federal income tax treatment of foreign currency. In the interest of the public, it is our duty to study, clarify, and develop the subject, to resolve uncertainties and remedy inequities.

The need for specialization occurs before the specialist is born. The need for international accountancy is here.

## I. TRANSACTIONS NOT INVOLVING THE OPERATION OF A FOREIGN BRANCH

### A. Blocked Currencies.

Indicative of the new importance of the subject under consideration is a reference to one aspect in the recent "Magill" report to the Ways and Means Committee of the House of Representatives.[1] It is there recommended that the Internal Revenue Code be clarified, to the extent necessary, to provide that foreign income should be included in taxable gross income only

[1] Special Tax Study Committee (Roswell Magill, Chairman), Report to the Ways and Means Committee, House of Representatives, November 5, 1947 (1947 P-H Fed. Tax Serv., Par. 76,288), Part 1, Par. 30(3).

when it can be transmitted to the United States in dollars.

This of course is the problem of "blocked" currencies—when and in what amount shall income earned in blocked currencies be included in gross income subject to tax.

1. *No rule generally applicable to all blocked currencies.*

The economic turbulence of the recent war and of the problem of reconstruction which followed in its wake introduced an infinite variety of Governmental controls on currencies. As a result the treatment of foreign currency in the federal income tax law must vary with the nature of the currency regulation in effect at the particular time, as it pertains to the particular taxpayer. Consequently the position of the Commissioner is that no general ruling can be made as to the treatment of income received in such restricted or blocked currency. [2]

The solution of any problem, then, requires, first, a factual analysis of the restrictions on the foreign currency in question at the relevant time and, second, a comparison of such factual situation with the published decisions.

Here, we will concern ourselves solely with a study of the treatment of the situations presented in reported decisions.

2. *Effect of power to convert into dollars.*

In the *International Mortgage* [3] case, the Board held that marks received by the taxpayer's agents in Germany were not taxable at the time of such receipt because the currency regulations prevented withdrawal of the marks from the country. In that case, the currency restrictions were so severe that there existed in this country no market for the blocked marks.

Suppose, however, the marks are blocked but that they may legally be transferred to persons desiring to use them within the foreign country. In such case, there may exist a market within the United States for sale of blocked currency. In *Credit & Investment Corp.*,[4] the restrictions permitted use of the marks within Germany for various purposes. The permitted use was sufficiently wide so that the marks were quoted in New York, although obviously at a figure substantially below the official rate. The Board held that the receipt of such marks resulted in taxable income to the extent of the value of the blocked currency.[5]

The foregoing cases appear to enunciate this rule: in order to be subject to tax on the receipt of blocked currencies, the taxpayer must have the legal power to convert the foreign currency into dollars.[6] Unfortunately, a subsequent decision casts some doubt on the validity of this simple rule.

3. *May blocked currency be taxable although not convertible into dollars?*

The case of *Eder v. Commissioner*[7] involved a foreign personal holding company in Colombia, South America. The Code, you will recall, requires the United States shareholder to include in his individual return the undistributed income of a foreign personal holding company. In the *Eder* case, under a decree of the foreign government, the undistributed earnings of the foreign company could not legally be trans-

[2] Letter to Prentice-Hall, Inc., dated December 17, 1940, signed Timothy C. Mooney, Deputy Commissioner by L. K. Sunderlin, Chief of Section, 1940 P-H Fed. Tax Service, Par. 66,452.

[3] *International Mortgage & Investment Corp.*, 36 BTA 187 (1937).

[4] *Credit & Investment Corp.*, 47 BTA 673 (1942).

[5] See also *United Artists Corp. of Japan*, P-H TC Memo. Serv., Par. 44, 210 (1944); *Stuart, James & Cooke, Inc.*, P-H BTA Memo. Serv., Par. 38,095 (1938); Mim. 5297, 1942-1 Cum. Bull. 84.

[6] Lassen, Blocked Accounts, 23 Taxes 238 (1945).

[7] *Eder* v. *Commissioner*, 138 F. 2d, 27, 43-2 USTC Par. 9519, 31 AFTR 627 (CCA 2, 1943); reversing in part *Phanor J. Eder*, 47 BTA 235 (1942); on remand, *Phanor J. Eder*, P-H TC Memo, Serv., Par. 44,156 (1944).

ferred outside the boundaries of that country. Nevertheless, the Tax Court held that the undistributed income of the foreign corporation was properly includible in the gross income of the taxpayer, on the ground that the specific provisions of the Code pertaining to foreign personal holding companies prevent application of the rules generally applicable to the taxability of foreign income.

The Tax Court computed the undistributed net income of the corporation at the rate of exchange for free (*i.e.,* unblocked) Colombian pesos. On appeal, the Circuit Court held that the valuation of blocked pesos at the rate for free pesos was improper. However, it agreed that the undistributed income was properly includible in the taxpayer's gross income. Even if the owner of blocked pesos could not legally have sold them for dollars to persons desiring to make investments in Colombia, there was nothing in the Colombian laws to prevent the taxpayer from investing or spending the blocked pesos in Colombia, thereby receiving "economic satisfaction" from such currency.

Because the *Eder* case involved a foreign personal holding company, it has been generally interpreted as not being applicable to the ordinary receipt of income in blocked currency. This assumption may not be entirely accurate.

Nothing in the foreign personal holding provisions indicates any deviation from the general principal that, for federal income tax purposes, income must be measured in dollars. Despite the reliance on foreign personal holding company provisions in the *Eder* opinions and a later decision "distinguishing" that case,[8] it is submitted that the *Eder* case may represent a new step in the treatment of blocked currencies; under certain circumstances, the receipt of foreign currency may be taxable income despite the fact that it cannot be converted into dollars.

The anomaly of restricting the *Eder* case to foreign personal holding companies and denying its application to the ordinary receipt of blocked currency may be illustrated as follows: Consider the case of a foreign personal holding company which earns 2 pesos. A dividend is declared of one of the pesos earned and credited to a blocked account, but the other pesos is retained. If the *Eder* case prescribes a different rule for a dividend in blocked currency than to undistributed income of such blocked currency, the result would be that the peso distributed as a dividend is nontaxable, but the retained peso is taxable. The obvious purpose of the statute was to treat similarly the distributed and undistributed income of foreign personal holding companies.

On the other hand, the *Eder* decision does not necessarily mean that the mere power to reinvest blocked currency within a foreign country, without the power to convert it into dollars, subjects the income to federal tax. The circumstances of the taxpayer involved would appear to have an important bearing. Mr. Eder was an attorney specializing in Colombian law, who spent a substantial portion of his time on Colombian affairs and in Colombia.

Thus, it is submitted, the *Eder* decision may be both wider and narrower than it appears. It may be wider in that it is not properly confined to the foreign personal holding companies. It may be narrower in that it is not applicable to ordinary citizens not traveling or investing extensively abroad, who would hardly gain any "economic satisfaction" from the blocked currency. Thus, a taxpayer who goes abroad and actually expends the blocked currency within the foreign country, or one who could have spent it but chose instead to spend dollars, or one whose investments and interest within the foreign country are so wide that he would achieve substantially the same benefit from the power to invest blocked currency within the foreign country as from dollars, may be taxable on the receipt of blocked cur-

[8] *United Artists Corp. of Japan,* P-H TC Memo. Serv., Par. 44,210 (1944), at p. 44—683.

rency even though it is not convertible into dollars. However, the *Eder* decision does not, it is submitted, require the imposition of a tax on blocked currency in the case of the ordinary taxpayer with a casual investment in a foreign country unless the blocked currency can be converted into cash.

4. *Valuation of blocked currency.*

A corollary to the rule that currency blocking may result in no taxable income is the rule that blocked currency should be valued at the rate at which the particular taxpayer is able to convert the currency into dollars. Thus, blocked currency is not necessarily to be converted at the official or controlled rate of exchange, or at the rate of exchange applicable to *free* currency, or at the rate of exchange certified by the Federal Reserve Board for customs duties.[9] The question is what amount of dollars could the taxpayer have received for the blocked currency at the relevant time. Sometimes there exists an open market rate for blocked currencies, quotations for which are available. These may generally be used for the conversion rate. Or it may be necessary to resort to expert testimony. In the *Eder* case, previously discussed, the value of the Colombian peso was determined by constructing a relative price index in the United States and Colombia on foods and other commodities commonly used.

## B. When Is Gain or Loss Recognized?

So much for blocked currency. Next, we turn to the question of when gain or loss should be recognized on some common transactions involving foreign currency. In order to prevent any confusion with your accounting conceptions, keep in mind that we are not discussing the operation of a foreign branch but transactions of less complexity and frequency within a foreign country.

1. *Buying and selling foreign currency.*

A clear case in which foreign currency is treated like any other commodity is that of a "dealer" in foreign exchange. Such a taxpayer is in the same position as a dealer in other commodities and the same rules applicable to other dealers are applicable to him. Thus, since his foreign currency represents inventory, it may be valued at cost, or at the lower of cost or market.[10]

Where the taxpayer is merely a *trader* or *investor* in foreign exchange, the right to inventory is denied.[11] Gains and losses on foreign currency transactions of a trader or investor are recognized only when the foreign currency is disposed of. Thus, in *P. Cannizarro Co.*,[12] the taxpayer was engaged in the tobacco business catering to the Italian trade in this country and required Italian lire to finance purchases of tobacco in Italy. As a result of unsettled conditions in Italy, the purchases were not made during 1919, and the lire were sold in 1920. The Board held that no loss was realized on account of the decline in value of the lire which occurred in 1919. The loss was not considered realized until 1920 when the lire were sold.

In the illustrations which follow, for simplicity I shall use a fictitious currency—a peso which is at first at par with the United States dollar, *i. e.*, a peso is worth $1.00. But subsequently the value of the peso drops to 50 cents.

2. *Purchases with foreign currency.*

Suppose instead of selling the foreign currency for dollars as in the *Cannizarro* case, the taxpayer acquires inventory for such currency. In *Bernuth Lembcke Co., Inc.*,[13] the taxpayer was in the business of importing oils. It pur-

[9] I.T. 3568, 1942—2 Cum. Bull. 112.
[10] O. D. 834. 4 Cum. Bull. 61 (1921); O. D. 940, Cum. Bull 64 (1921).
[11] See note 10.
[12] 19 BTA 380 (1930).
[13] 1 BTA 1051 (1925).

chased pesos at par, *i.e.,* for one dollar. Later the peso fell to 50 cents. While the peso was at $.50, the taxpayer purchased oil at one peso per unit of oil. It paid for it in pesos which cost it one dollar. The Commissioner argued that each unit of oil should be included in inventory at $1.00, the *cost* of the peso used to buy the oil. The Board, holding for the taxpayer, treated the peso like any other commodity. Therefore, the exchange of pesos for oil was a taxable exchange and a loss of $.50 was realized on disposition of the pesos at the then value of $.50, since they had cost the taxpayer $1.00. The cost of the oil was $.50 which represents the value in dollars at the date of purchase.

In *Joyce-Koebel Co.,*[14] the taxpayer was also an importer, purchasing diamonds on credit payable in pounds. The Board held that the cost of the diamonds is determined by the rate of exchange at the date of purchase of the diamonds. Any gain or loss on the difference between the rate at the date of purchase and at the date of payment must be accounted for separately.

3. *Foreign sales and services.*

In the case of foreign *purchases,* we have seen that the cost of the goods acquired is valued at the rate of exchange on date of purchase, regardless of the rate at date of payment. Parallel reasoning would require that foreign sales be entered at the rate of exchange at date of sale regardless of the rate when payment is received. One commentator[15] states the rate at the time of receipt governs and two early rulings[16] seem to support him. It is typical of the unsettled status of foreign exchange problems that this elementary problem should be unsettled at this date.

Payment received in foreign currency for services rendered by a recipient on the cash basis would be included in income at the rate of exchange at the date of receipt. For example, commissions payable in Canadian currency to U. S. citizens working in Canada should be converted at the rate at the time each commission is paid or credited to the employee's account.[17]

4. *Payments on foreign accounts.*

Assuming that the accounts receivable or accounts payable in foreign currency are to be set up at the rate of exchange at date of the sale or purchase, as the case may be, how is gain or loss to be recognized on payment thereof? Consistent with the treatment of foreign currency as a commodity, there would appear to be no gain or loss before the debt is paid. Thus, in *Joyce-Koebel Co.,*[18] where the taxpayer purchased goods on credit payable in pounds sterling, the Board refused to convert the accounts payable at the end of the year at the rate of exchange at the balance sheet date.

5. *Foreign investments.*

With respect to foreign investments, where bonds payable in foreign currency or stocks in foreign corporations are purchased for investment, no gain or loss is realized until the securities are sold or become worthless. No deduction is allowed merely because of a decline in rate of exchange.[19]

Dividends in foreign currency are convertible at the rate of exchange at the date of receipt,[20] whether the taxpayer is on the cash or the accrual basis.

6. *Foreign borrowings.*

A recent case illustrates the confusion of the law of foreign exchange. In the

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[14] 6 BTA 403 (1927); compare Accountant's Handbook 928 (3rd ed., Paton, 1943); but see O. D. 489, 2 Cum. Bull. 60 (1920).

[15] Shepard, Foreign Exchange—Tax Consequences, 1 Tax Law Rev. 232, 233, n. 14.

[16] O. D. 419, 2 Cum. Bull. 60 (1920); O. D. 459, 2 Cum. Bull. 60 (1920).

[17] O. D. 1066, 5 Cum. Bull. 66 (1921).

[18] See note 14.

[19] *Haviland* v. *Edwards,* 20 F. 2d 905 (CCA 2, 1927); A. R. M. 31, 2 Cum. Bull. 128 (1920); *Hugo F. Urbauer,* 7 BTA 846 (1927).

[20] *Frank W. Ross,* 44 BTA 1 (1941).

*Coverdale*[21] case, the situation was essentially this: the taxpayer borrowed pesos when the peso was worth a dollar and used the pesos to purchase stock, which stock was later sold at a substantial loss. When the loan in pesos fell due, the peso had dropped to 50 cents. So the taxpayer acquired pesos at 50 cents and repaid the loan. The taxpayer's return reflected the 50 cents gain as a capital gain. The Commissioner argued that it was ordinary income. The Tax Court agreed with neither and held that it was nontaxable. This holding seems wrong.

Suppose, when the peso is at par with the dollar, A borrows 100 pesos. With the 100 pesos A can acquire $100 cash or 100 shares of stock, or 100 units of inventory. By the time the loan falls due, the rate of exchange of the peso has declined to 50 cents. Hence, A buys 100 pesos for only $50 and repays the loan. If A had used the 100 borrowed pesos to acquire $100 cash which he still retained, it is obvious that his wealth has increased by $50. Should it make any difference that he used the 100 pesos to buy stock or inventory?

No quarrel can be had with the Court's major premise:

> "We have consistently held that a borrowing and returning of property cannot result in taxable gain."

However, this proposition hardly disposes of the issue. If I borrow 100 shares of General Motors common stock and repay the 100 shares, clearly, as the Court says, no gain or loss results. However, if I have sold the 100 shares borrowed (as in the common short sale of stock), the subsequent repayment of the loan would clearly represent the point at which gain or loss is computed. The gain is not on repayment of the borrowed stock. But the repayment represents the act which completes the transaction and marks the time for taxing the proceeds on the sale of the borrowed stock.

Suppose instead of borrowing 100 shares of General Motors, I borrow 100 pesos. Should there be any different result?

The similarity of borrowing foreign currency to a short sale of stock was brought up early in litigation on the subject. *Bowers* v. *Kerbaugh Empire Co.*[22] involved a situation similar to the *Coverdale* case. To the Government's contention that "in substance and effect the transaction was a 'short sale' of marks", the Supreme Court responded that there was "no similarity", for the following reason:

> "A short seller borrows what he sells and the purchase price goes to the lender and is retained as security for repayment. The seller receives nothing until he repays the loan."

This does not seem to meet the Government's contention. The Court accurately states a characteristic of the common short sale of stock. True, the purchase price is generally retained by the lender as security. However, certainly no different income tax treatment would result if, in a particular short sale, the lender were willing to trust the general credit of the short seller with the result that the proceeds would be received and expended by the borrower. The distinction advanced by the Supreme Court, it is submitted, affords no reason for treating the borrowing of foreign currency differently from the borrowing of stock.[23]

The principal case relied upon for the *Coverdale* decision is *The B. F. Goodrich Co.*[24] There the taxpayer borrowed francs and, in turn, loaned the same francs to a subsidiary. After the francs had dropped in value, the taxpayer repaid the loan. The Tax Court held that no gain was realized. The *Coverdale* opinion rests largely on this precedent, considering it indistinguishable from the case at bar.

On the contrary, it is submitted that analysis reveals a broad distinction be-

21 *William H. Coverdale*, P-H TC Memo. Serv., Par. 45, 240 (1945).
22 271 U. S. 170 (1926).
23 Compare Magill, Taxable Income 249 (1945).
24 1 T. C. 1098 (1943).

tween the two cases. The *Goodrich* case is entirely consistent with a treatment of foreign borrowings as a short sale. The *Coverdale* case is not.

A short sale of stock is merely an inverted ordinary sale. In a short sale, the sale precedes the purchase. The transposition is accomplished by borrowing the stock to be sold and repaying the borrowing by stock otherwise acquired. Nevertheless, as in an ordinary sale, no gain or loss is recognized until there exists a sale or exchange.

However, the mere lending of property does not represent the required "acquisition". Thus, if T borrows stock and, instead of selling it, lends it to another, there is no gain or loss recognized even after T purchases stock to cover the borrowing. What started as a short sale ends as a simple loan of purchased stock.

There in lies the distinction between *Goodrich* and *Coverdale*. In *Goodrich* no gain or loss was realized because there was no sale or exchange of the borrowed francs, merely a loan. The borrowed francs had been "covered" by the repayment of the loan with domestic currency. Nevertheless, there had been no taxable disposition of the francs, since they had been loaned in kind to another. The taxpayer in *Goodrich* was in the position of a broker who had borowed a share of stock from A, loaned it to B, and then purchased a share of stock to cover his borrowing from A. At this point, no gain or loss is recognized.

The *Coverdale* case is also inconsistent with the cases discussed earlier on purchases abroad on credit. If I buy merchandise on credit when the peso is at par with the dollar but the peso drops to 50 cents by the time I must pay for it, the *Coverdale* decision would appear to hold that the 50 cents gain is not taxable.

Until the *Coverdale* case is overruled, it stands as authority for the nontaxability of an actual gain. As I have indicated, I believe the *Coverdale* decision is wrong. Later cases may distinguish this on the alternate ground or *dictum* of the opinion. The stock acquired with the foreign currency was sold at a substantial loss and in the transaction as a whole, (that is, considering the sale of the stock and the repayment of the loan together) the taxpayer did not profit from the transaction. This is the rationale of the *Kerbaugh Empire* case which has been severely criticized by commentators and limited in later decisions so that little of it appears to be left. It has no more basis for application in foreign exchange than elsewhere in the field of federal taxation.

*7. Capital or ordinary gain or loss.*

The classification of transactions in foreign currency as between capital and ordinary income or loss presents serious difficulty which arises because the Code fails to give adequate consideration to the peculiar character of transactions in foreign currency.

Not until 1946 did any case or ruling consider this problem. In I. T. 3810,[25] the taxpayer, while travelling in Mexico, purchased pesos which he later converted into dollars. The ruling held that the gain or loss was a *capital* gain or loss. It does not appear that the taxpayer involved acquired the pesos in connection with any business transaction. However, the ruling indicates no limitation except in the case of a dealer in foreign exchange, stating:

> "Transactions in foreign exchange are generally considered as involving the purchase and sale of foreign currency, either in the conduct of a trade or business or as a speculation or investment."

No quarrel can be had with the ruling insofar as it pertains to foreign currency acquired as a speculation or as an investment. The treatment of foreign currency as a capital asset in such case seems proper, analogous to the treatment of speculation or investment in any other commodity. But suppose that the foreign currency is acquired

[25] 1946—2 Cum. Bull. 55.

for the purchase of inventory in the ordinary course of business and is expended for that purpose. Is the sale or other disposition of the foreign currency in such case to be treated as a capital gain or loss? It is submitted that a good case may be made out for treating it as an ordinary income or deduction. The cases cited by the ruling do not sustain the position that gain or loss on sale of foreign currency must always be treated as capital gain or loss.

The difficulty stems from the fact that, in order to avoid the treatment as capital gain or loss, the foreign currency must come within one of the exceptions to the definitions of capital assets. Foreign currency acquired as a result of sales abroad in the regular course of business may be found to be non-capital assets on the theory that such foreign currency comes within the following exceptions to the statutory definition of capital assets:[26]

> "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *."

There is strong analogous authority for the proposition that foreign currency received in the ordinary course of business for services or in payment of the sales price is not a capital asset. In one case[27] the taxpayer, engaged in the construction and repair of levees, showed that it was the custom of the levee districts to make payments for services in bonds, which it sold as soon as possible. Although the depression prevented the sale of certain bonds for several years, the Board considered that the intent to sell remained and that the bonds were not capital assets. In the *Gilbert*[28] case, preferred stock received in payment of construction work was held a noncapital asset. The Court felt that the statutory exception from classification as a capital asset included "all property which was owned by the taxpayer in connection with his business and held primarily for sale, but which was not stock in trade or part of his inventory."

If foreign currency acquired as income is a noncapital asset, the same should be true of foreign currency acquired for the purchase of property. In the *Gilbert* case, in addition to 500 shares of stock acquired in payment of services, the taxpayer purchased 79 shares of the same stock in order to protect the 500 shares. All 579 shares were held non-capital assets.

Of course, the treatment as capital gain of the sale of foreign currency may be an advantage to the taxpayer. Suppose, for example, that income is received when blocked but that there exists a market for the blocked currency. Hence, the income is reported at the low rate applicable to blocked currency. If the currency should later become unblocked, the sale or other disposition at a higher value may result in a gain. It may be advantageous to treat such gain as capital gain.

## II. TRANSACTIONS INVOLVING THE OPERATION OF A FOREIGN BRANCH

The treatment accorded transactions in foreign currencies differs substantially when the operations of a foreign branch are involved. The Accountant's Handbook[29] states that the reason for such difference is the complexity and multiplicity of branch transactions which make it inconvenient or impractical to translate each transaction into dollars.

There is only one court decision[30] involving foreign branch accounting. The decision established two points: *first,* that the income of a foreign branch may be computed by valuation of cur-

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26 IRC, Sec. 117 (a).

27 *Joe B. Forston,* 47 BTA 158 (1922); compare *Hercules Motor Corp.,* 40 BTA 999 (1939).

28 *Gilbert* v. *Commissioner,* 56 F 2d 361 (CCA 1st 1932).

29 See note 14.

30 *Frederick Vietor & Achelis* v. *Salt's Mfg. Co.,* 26 F. 2d 249 (D. C. Conn. 1928); see also O. D. 489, 2 Cum. Bull. 60 (1920).

rent assets and liabilities at the beginning and the end of the year at the rate of exchange at the date of the balance sheets; and *second* that foreign currency held for investment in the stock of a new enterprise may not be valued at the rate of exchange at the end of the year.

The usual method suggested by accountants for conversion of assets at the balance sheet date is as follows:[31]

Fixed assets and long-term liabilities: at the rate of exchange at the date of acquisition.

Current assets and liabilities: at the rate at the date of the balance sheet.

The effect of this "balance-sheet" method of computing gain or loss of a foreign branch is to consider as realized gain or loss the fluctuation in foreign currency prior to any sale or exchange. Thus, suppose a branch is set up with two pesos when the peso is worth one dollar and, while the rate of exchange remains unchanged, earnings increase the foreign cash to three pesos. If, subsequently, the peso falls to $.50, the balance-sheet method would show a loss of $.50. At the beginning of the year, the balance sheet reflected two pesos, which represents $2 at the rate at the date of the opening balance sheet. At the end of the year the balance sheet shows three pesos but, converted at the rate at the date of the closing balance sheet (50 cents) this represents only $1.50 (3 x $.50). Hence the difference in dollars at the beginning and end of the year ($2 — $1.50) results in a loss of $.50. Actually, the branch earned one peso, which (had it not been a branch operation) would have been converted at the rate at the date it was earned or $1.00, so that the earnings, apart from the fluctuation in the exchange were 1 peso or $1.00. However, under the balance sheet method of determining income, the $1.00 profit is offset by a decline in value of the peso. Since the branch had three pesos which declined to 50 cents in value (or a total loss from such decline of $1.50) the $1.00 profit on operations, less the $1.50 loss on decline of the peso, results in a net loss of $.50.

One problem that does not appear to have received any attention is the delineation of classes of transactions occurring during the year. For federal income tax purposes, it often becomes important to break down the net profit for the year into separate classifications. Many of these are for the benefit of the taxpayer so that as accountants we must not overlook such a segregation. For example, included in the net profit (or loss) of a foreign branch may be a gain on the sale of a capital asset, a gain on the sale of depreciable property under IRC, Section 117 (j), cancellation of indebtedness which may be nontaxable under the doctrine of the *American Dental* case or under Section 22 (b) (9), a recovery of a bad debt deducted in a loss year within Section 22 (b) (12), or redemption of securities under Section 117 (f). The careful tax practitioner will not permit the "balance sheet" method of computation to blind him to the advantage of those provisions. It must be recognized, however, that the balance sheet method will present serious problems in the segregation of the amount of such special class of income from the ordinary income of the branch.

As must be evident at this point, the last word has not been said on the problem of foreign exchange problems. If any claim can be made for this paper, its contributions lies primarily in bringing to light problems which have apparently lain dormant and undeveloped despite the strides made in federal income tax accounting in other fields. Toward that narrow achievement, I hope it has been helpful.

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[31] Accounting Research Bulletin No. 4 (Dec. 1939); Saliers, Foreign Exchange Accounting, 19 Acctg. Rev. 377 (1944); Kirchenberg, Principles of Foreign Trade Accounting, 11 N.Y.C.P.A. 316 (1941).

# How to Get the Greatest Use of the Net Operating Loss Deduction

*By* Ludwig B. Prosnitz, C.P.A.

**Is a five year cycle adequate?**

Ordinarily when we think of a taxpayer's liability under the income tax laws, we do so in terms of a calendar or fiscal year, as the case may be. The net operating loss provisions of the Internal Revenue Code, however, give recognition to an economic fact, namely, that a tax year of a business concern creates merely a convenient, however artificial dividing line.

It was deemed necessary to grant relief to those concerns that realized gains in one year and losses in succeeding or prior years. As a result we now have a stated cycle of five years, generally speaking, within which business concerns can offset their gains and losses. A business net operating loss incurred in one year can be carried back and applied to the profits of the two preceding years. If the loss is not thereby completely absorbed, the unabsorbed portion can be carried forward and applied against the gains of the next two succeeding years.

The question arises whether this five year cycle embodied in the Internal Revenue Code is an arbitrary one or whether it is based upon an analysis of American industrial history. If within reasonable limits, a case can be made out statistically for the five year cycle, there is justification for its retention in the net operating loss provisions. If, however, study should disclose that a longer cycle is needed to reflect fairly the net operating results in American industry, there would be need for further liberalizing the net operating loss provisions.

The position of new enterprise with respect to the net operating loss provisions deserves special consideration. It is not uncommon for concerns to operate initially at a loss. They cannot benefit from the carry back provisions, and are therefore limited to the two year carry-over. The cycle for new concerns, that incur losses in their first years of operation, is accordingly reduced to three years. Serious consideration should be given to changes that would encourage new business. In fact, the Treasury Department recently issued a statement advocating the substitution of a five year carry forward in place of the existing practice of carry back and forward. This is a constructive thought as to new enterprise but it is questionable whether elimination of the carry back would be equitable to established concerns that have to contend with varying earnings because of the changing business cycle.

The status of a new concern may be compared in some ways with that of a business that has been engaged in war

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This article is based upon a recent address made by him in the Federal Tax Lecture Series conducted by the Society's Committee on Federal Taxation.

work. While it has enjoyed a period of prosperity, it may very well face heavy operational deficits in the early years of peace time operation. It can incur these losses with a relative degree of long range confidence because of the existence of sound carry-back and carry-over provisions of the Internal Revenue Code.

**How to compute the net operating loss deduction**

Section 23 (s) of the Code provides for the deduction by taxpayers of a net operating loss for any taxable year beginning after December 31, 1939, and provides that it be computed in accordance with Section 122.

In the case of a taxpayer other than a corporation, Section 122 (c) states that the amount of the net operating loss deduction shall be the aggregate of net operating loss carry-overs and carry-backs to the taxable year—reduced by the amount of the net income, computed with certain exceptions and limitations mentioned in subsection (d). In the case of a corporation the definition refers to the excess of deductions over normal tax net income.

Section 122 (b) relates to the determination of the amount of the carry-backs and carry-overs. Stated broadly, the statute calls for a two year carry-forward of losses of 1939 and subsequent years, a one year carry-back of 1942 losses, and a two year carry-back for losses of 1943 and subsequent years.

For example, a 1943 loss is first applied to 1941. If it is not absorbed by the income of that earlier year, the unabsorbed portion is applied to 1942, which is the year preceding the taxable year. If the loss is not thereby completely absorbed, the unabsorbed portion may be carried over, first to 1944 the year following the taxable year under consideration, and if not then absorbed, the unabsorbed portion may be applied to the second year following the taxable year, which would be 1945.

In determining a net operating loss deduction, it should be borne in mind that the intent of the statute is essentially to give relief to business. Non-business deductions (including the standard deduction under Section 23 (aa)) can therefore be included in the computation of the net operating loss deduction only to the extent of non-business income. Any excess of non-business income reduces the net operating loss carry over or carry back.

The net operating loss deduction, when determined, may be carried back and/or forward and applied against other items of income.

**Ordinary loss or capital loss? Important court cases**

It is readily apparent that if some transactions of either an individual or a corporation are adjudged capital losses instead of bsuiness losses, it would result in a lower net loss deduction. An item in point would be if a bad debt were determined to be a non-business instead of a business bad debt.

In a Tax Court case involving *Reo Motors, Inc.* (9 TC 47), the company, because of the worthlessness of its subsidiary's stock, sustained a loss in 1941 which it desired to carry over to 1942. Under Section 23 (g) of the law in 1941, such a loss was a capital loss. Under the 1942 Act, the loss was an ordinary loss. The court concluded that under Section 122 (d) (4), the 1941 rule had to apply and the loss could not be recognized for the purpose of a net operating loss deduction in 1942.

It is interesting that one of the judges did not concur in the majority opinion and this same judge wrote the opinion of the Tax Court in an earlier case, *Moore,* 4 TC 404. In that case, the years 1941 and 1942 were also involved with the difference, however, that the treatment of net capital losses was at issue instead of the loss of investment in a subsidiary. The Court held that the operating loss should be computed in accordance with the law in effect in the year to which the loss is carried over, in this instance 1942. This appears to conflict with the *Reo* case. The

*Moore* decision was affirmed in the 2nd Circuit. It may well be that we will hear further from the courts on this subject.

In another case, *Merrill*, 9 TC 44, Merrill was a general partner in a partnership with a stipulated term ending December 31, 1939. He had been permitted to retire as of March, 1939. A year later Merrill and his firm executed an agreement whereby releases were exchanged and a pro-rata share of certain recoveries on unliquidated accounts were assigned to Merrill as of March 30, 1940. Merrill claimed an ordinary loss of over $103,000 in his 1940 return, ascribing such loss to his partnership activities. This resulted in a net loss on his return of $41,000, which Merrill claimed as a deduction as a net loss carry over to 1941.

This deduction was disallowed. It was held that the transaction that brought about Merrill's retirement was a capital transaction, not related to the business of the partnership and, under the limitation of Section 122 (d) (5), Merrill had no operating loss in 1940 which he could carry over to 1941.

### To whom available. Treatment under Section 102 and application to personal holding companies

The net operating loss deduction is available to individuals, corporations, estates and trusts, the individual members of partnerships, and to insurance companies.

It is not available to personal holding companies, either foreign or domestic, mutual investment companies and common trust funds maintained by banks. However, the participants in such trust funds are entitled to the net operating loss deduction.

For the purpose of determining undistributed net income of a personal holding company, the net operating loss of the preceding taxable year (less tax exempt income and the excess of percentage depletion over cost depletion) is allowable as a credit under Section 26 (c).

The net operating loss deduction under Section 122 may not be used as a deduction to compute net income under Section 102 (dealing with the unreasonable accumulation of Surplus). However, the net operating loss of the preceding taxable year may be used as a credit under Section 26 (c) in determining Section 102 net income. The net operating loss of the preceding taxable year may also be used as a credit in determining the net income of foreign and domestic personal holding companies under Supplement P of Chapter 1 and Subchapter A of Chapter 2, I.R.C. respectively. Such a credit for the net operating loss of the preceding year cannot, however, exceed the net income for the taxable year computed under such Section 102, or Supplement P or Subchapter A as the case may be. In computing the net operating loss credit under this section, the exceptions, limitations and additions in connection with depletion and interest, mentioned below, also apply.

### Exceptions, limitations and additions

As stated above, the net operating loss deduction concerns itself with the excess of business loss over business income. There are, however, certain exceptions and additions covered by Section 122 (d). These refer to the limitation of the depletion deduction; the elimination of certain exempt interest income; and the deduction and the exclusion of certain interest. The gains or losses on sales of capital assets are also excluded, and non-business deductions are limited to the extent of non-business income.

In the case of a corporation the amount of excess profits tax paid or accrued is also allowed as a deduction. This tax is, for this purpose, not to be reduced by any foreign tax credit, and is to be computed without regard to adjustments for inconsistencies under Section 734.

**Seven year cycle in exceptional cases**

I have previously referred to the five year cycle. However, in certain exceptional cases, the effect of a net operating loss carry back may be spread over a 7-year period. For example, assume Corporation "X" has profits in the years 1943, '44, '46 and '47. In 1945, however, a loss was sustained, which exceeded the combined profits for the years 1943, '44 and '46. In the years 1941, '42, '43 and '44, excess profits taxes were paid on a portion of the profits.

As a result of this large loss in 1945, a carry-back was created to the years 1943 and 1944 which wiped out the income for those years, and at the same time made available unused excess profits credit carry backs to the years 1941 and 1942.

Accordingly, the 1945 loss created the following situation:

1941–2 Refunds as a result of unused excess profits credit carry-backs.

1943-4 Refunds as a result of operating loss carry-backs.

1946–7 Reduction in taxes as a result of operating loss carry-over.

A special alternative period of limitation with respect to claims for refund arising from the application of net operating loss carry-backs or unused excess profits carry-backs is embodied in Section 322 (b) (6). Such claims are valid if filed within 38½ months after the close of the taxable year in which the carry-back arose. For example, in the foregoing case claims for refund for the years 1941 and 1942 could be filed up until March 15, 1949.

**Considerations affecting new businesses**

A new concern when it establishes its fiscal period might well give some consideration to its carry-over situation. If the enterprise is of moderate size and enjoys fair profits at the outset, it might want to give consideration to the corporate tax brackets and perhaps close its first fiscal period at a point where earnings of approximately $25,000 net have been achieved. If the enterprise sustains initial losses and these losses continue, it would be desirable to create the maximum possible carry-over to subsequent years by having the fiscal year end with the first 12 months.

**Considerations affecting "close" corporations**

Let us consider the case of a corporation with a fiscal year ended June 30th, whose stock is closely held, and has the following situation:

| | |
|---|---|
| Profits for Year (6/30/45) after officers' salaries of $50,000 to each of 2 officers | $100,000 |
| Profits for Year (6/30/46) after same officers' salaries | 75,000 |
| Excess Profits Credit each year including specific exemption | 70,000 |

Operations for the 1947 fiscal period show a loss of $50,000 before the deduction of officers' salaries. Officers' compensation for the years 1944 and 1943 had been in dispute with the Treasury, but were settled without disallowance. The officers' salaries for the fiscal year 1947 must be decided upon (assuming this decision is held in abeyance until the end of the fiscal year which is, I suppose, a rare occurrence in the case of closed corporations.) Any salary credits to the accounts of the stockholder officers in a loss year, would in effect constitute payments by the corporation to its stockholders out of its accumulated capital. Let us examine the tax effect if salaries are allotted at $50,000 each.

| | |
|---|---|
| Loss before salaries | $ 50,000 |
| Salaries | 100,000 |
| Total Loss | $150,000 |

| | |
|---|---|
| Taxes paid by the corporation for the fiscal year 1945 amounted to | $ 53,650 |
| Taxes paid by the corporation for the fiscal year 1946 amounted to | 32,250 |

Applying the operating loss carry-back, from the fiscal year 1947 to the fiscal year 1945, the original profit of

$100,000 is converted to a carry-over loss of $50,000 to the fiscal year 1946. The taxable net income of the latter year becomes $25,000, the tax on which is $6,750. The corporation thereby becomes entitled to a refund of

| | | |
|---|---|---|
| | $53,650 | for 1945 fiscal year |
| and | 25,500 | " 1946 " " |
| a total refund of | $79,150 | (exclusive of any |

refunds resulting from unused excess profit credit carry-backs.)

The taxes payable by the individuals, (assuming no other income), on the salaries of $50,000, would be about $25,000 each. Accordingly, the economic unit represented by themselves and their corporation gains an aggregate of close to $30,000, exclusive of excess profits tax refunds, if such taxes were paid, by the continuance of their salary set up. This is over and above the probable discomfiture involved in attempting to support with the Treasury, substantial salaries in the earlier and later years, compared with nominal or zero compensation in the current loss year.

### Considerations affecting parent and subsidiary corporations

Now consider another situation involving a wholly owned subsidiary which has an accumulated operating loss of $100,000 for six months of its calendar year 1947. The parent has a profit of $50,000. The outlook for the rest of the year is that the subsidiary will sustain further losses which may total $250,000 by the year-end, and that the parent will end up with a net profit of $100,000.

The subsidiary can carry back its net loss to its aggregate profits of the preceding two years which amounted to $50,000 in each year. This will leave it at the end of the year with a loss to carry over to the next succeeding years of $150,000. However, the outlook of the subsidiary for future earnings is not bright. The parent had net income aggregating $40,000 in each of two prior years, or a total of $80,000.

Three possibilities present themselves:

1. To liquidate the subsidiary as of June 30th.
2. To continue the subsidiary and file consolidated returns as of December 31st.
3. To continue the subsidiary and file separate returns as of December 31st.

Disregarding any unused excess profits credit carry-backs and assuming no excess profits taxes, the three choices would work out as follows:

1. Liquidating the subsidiary as of June 30th would enable the subsidiary to apply its $100,000 current loss against prior years earnings of $100,000 which would produce a refund of about $38,000.

The parent by virtue of having absorbed the subsidiary would inherit its losses of the last six months and thereby finish the year with a net loss of $50,000. This would be applied against the profits of the parent of 1945 and '46 (of $80,000) and result in a refund of about $19,000 (38%). The refunds therefore total $57,000, with $30,000 of income still available against which a loss if sustained in 1948 can be applied.

2. If the subsidiary is continued and consolidated returns are filed at year end, the consolidated loss will be $150,000. The gains of both companies for the two preceding years aggregate $180,000, of which $80,000 applies to the parent and $100,000 to the subsidiary. Inasmuch as the subsidiary incurred the loss of $250,000, in consolidation this loss can be carried back only against the prior profits of this subsidiary. (Regulations 104—Sec. 23.31 (b)(2).

Result:

| | |
|---|---|
| Refund on prior earnings of subsidiary ......... | $38,000 |
| Loss carry-over available (consolidated) of..... | $50,000 |

3. If the subsidiary is continued and

separate returns are filed the parent will pay a tax on $100,000 of $38,000. The subsidiary will apply its loss of $250,000 against its prior income of $100,000 and receive a refund of $38,000.

Result: No tax and loss carry-over available of $150,000.

From the foregoing it must be concluded that if the subsidiary is to continue to have operating losses, it should be liquidated as of June 30th. If, however, the subsidiary can be placed on a profitable basis, it would be desirable to continue its operations and file separate returns. This would make a loss carry-over of $150,000 for two more years.

**Should the form of business organization be changed?**

Businesses that contemplate a change from corporate operation to individual or partnership operation, or the reverse, should carefully review their possible carry-back and carry-over situations before doing so. The net operating loss deduction generally does not extend from one taxpayer entity to another. The Supreme Court in the case of *New Colonial Ice Co.,* 292 U. S. 435, stated: "A successor cannot deduct a net operating loss suffered by a predecessor."

**Should the accounting period be changed?**

A concern that changes its accounting period should also give consideration to the matter of potential carry-overs and carry-backs. The carry-back and the carry-forward are taken back and forward to a taxable year of the taxpayer, which need not be a full 12 month period. For example, assume that we have a profit of $3,000 for a short period of three months and then the fiscal year is changed. Assume that the next two years have each losses of $12,000. These losses can be carried back against the profit of $3,000 because the taxable year was the short period of three months. This is as it should be because the taxpayer, even though the short period was annualized, nevertheless, paid a tax on only $3,000 of net income for 3 months.

In considering the question of change of business organization and change of accounting period, I am not unmindful of the fact, that considerations other than taxes are involved. These must be weighed with the tax factors and a conclusion reached based upon all the attendant circumstances.

**Tentative carry back adjustments because of expected losses**

Section 3779 of the Code provides for the postponement of the payment of taxes in the event that operating loss carry-backs are expected for any taxable year ending on or after September 30, 1945. The extension applies to taxes due in the loss year for the year immediately preceding. A statement is required to be filed on Form 1138 and cannot relate to any tax that was due prior to the time the statement was filed.

In substance Form 1138 calls for a full statement of the expected loss and/or unused excess profits credit and the amount of the adjustment requested. The filing of the form brings about an extension to the end of the month in which the return was due, showing the net operating loss carry-back. In other words, a 1946 tax, due in 1947, would be extended to March 31, 1948. Interest is charged at 3% per annum on the amounts extended from the date the original quarterly installments were due to the extended date. If a tentative carry-back adjustment is not approved, the interest is increased to 6%. Further a penalty of 5% is charged if the amount of the claim is over 125% of what it should have been and is computed on the amount of the excess over 125%.

**Applications for quick cash refunds**

Another section in the Code (3780) was enacted to enable taxpayers to obtain quick cash refunds. It provides for an application on form 1139 to be used in cases after the return has been filed

for the taxable year in which the carry back arose. This application must be filed within one year after the close of the taxable year.

While the relief granted by Section 3779 is available to corporate taxpayers only, 3780 may be used by taxpayers other than corporations, who sustained a net operating loss carry back.

Filing of claims on forms 1138 and 1139 has no effect on the statute of limitations with respect to the filing of refund claims. Such claims under Section 322 may be filed, before, simultaneously with, or after the filing of an application for a tentative carry back adjustment.

An application form 1139 must be acted upon by the Commissioner within 90 days from the date of filing of the claim or within 90 days from the last day of the month in which the return is due, whichever is later.

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The carry back provisions have proved of tremendous importance in the reconversion period following the close of World War II. Considerable progress has been made in this direction and doubtless further developments can be expected. But it is clear that high rates of taxation make it imperative that the revenue laws continue to give recognition to the fluctuating American business cycle.

## SHOULD FINANCIAL STATEMENTS OF PARTNERSHIP SHOW ANY LIABILITY FOR FEDERAL INCOME TAXES?

This question is frequently raised by credit grantors as well as by other users of financial statements. It is a natural question since the partnership is the only common form of conducting a business which does not show the provision and liability for federal income taxes in its financial statements. In the cases of corporations and individual enterprises, the other two common forms of doing business, the federal income taxes are a liability of the corporation or of the individual conducting the enterprise and there is no question but that the liability should be shown on the balance sheet or statement of assets and liabilities and that the provision therefor should be shown as a charge in the profit and loss account. However, in the case of partnerships the liability for federal income taxes on the profits of the partnership is not a partnership liability but is the liability of the individual partners.

In addition to this legal technicality there is a very practical problem in that it is often impossible for the partnership as such to determine the taxes that will have to be paid on the partnership income. In order to make such a determination it is necessary to know the particulars of the taxable income of each partner and in many cases a partner might quite properly not wish to disclose this information to the other partners. Because of these facts it has become almost universal practice in submitting financial statements of partnerships not to include in the profit and loss account a charge for the income taxes of the partners payable on the partnership income and not to show as a liability the unpaid portion of such taxes. Also many partnership financial statements contain a footnote stating that the income taxes on the partnership income are payable by the partners and calling attention to the lack of provision therefor by the partnership.

The fact that income taxes claim such a large portion of the income of any enterprise probably gives rise to the argument that regardless of these facts some provision for these taxes should be made in parrtnership statements. But, is there any more reason to show the income tax liabilities of the partners in partnership financial statements than to show other liabilities of partners in those statements?

It would seem to me that in loaning to a partnership if the credit grantor is looking to the partnership assets for repayment he is interested in all of the demands that might be made for the use of those assets and not only in one demand such as one for income taxes. If I am correct in that assumption is not our present problem met by (1) the accountants insisting that financial statements of partnerships contain an explanatory comment that no provision for income taxes is made and no liability is shown since the liability is that of the partners and not that of the partnership and (2) the credit grantor obtaining from the borrower a statement as to what withdrawals are anticipated by the partners whether for tax or for any other purposes.

—The foregoing note was written by J. Robert White (partner, Price, Waterhouse & Co., Los Angeles, Cal.) and appeared originally in the December, 1947, Bulletin of the Robert Morris Associates.

# Income Tax Decisions of 1947

*By* Jack Schlosser, C.P.A.

In retrospect it seems to the writer that he spent almost as much time in selecting the title for the article that follows as he did in its actual preparation. A title must serve not only as a description of the contents in capsule form, but should also set forth to some extent, its scope and significance. With this in mind the writer discarded in quick succession "The Most Important Tax Decisions of 1947", "More Important Tax Decisions of 1947", and finally "Important Tax Decisions of 1947". After considerable deliberation the very undramatic but indisputable title "Income Tax Decisions of 1947" was selected. Thus, the discussion that follows will be confined only to income tax cases and the question of the relative importance of the decision submitted will be left, as it should be, to the appraisal of the individual reader.

The Supreme Court issued at least 4 decisions during 1947 which may be considered as having widespread interest to tax practitioners.

*Beulah B. Crane* v. *Commissioner* (331 U. S. 1).

The petitioner, Mrs. Crane, inherited rental property subject to a mortgage which she did not assume. The property was valued for estate tax purposes at the amount of the mortgage, so that the petitioner's equity in the property at date of death was of zero value. Mrs. Crane operated the property for a number of years and then sold it subject to the mortgage, receiving $2,500 as her net proceeds. She reported this entire amount as a long-term capital gain on the sale of an equity in property having no cost basis.

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Needless to say, Mrs. Crane's position was contrary to all prevalent practice. Recognizing the gravity of the situation the court held:

> (1) The basis of property acquired subject to an unassumed mortgage is determined, not on the equity, but on the physical property.
>
> (2) The basis of said property must be reduced by depreciation allowed or allowable computed on the full amount of the basis undiminished by any mortgages.
>
> (3) Upon sale of such property, the "amount realized" must include the principal amount of mortgages assumed by the buyer even though seller was not personally liable therefor.

Thus, accepted accounting and tax practice was vindicated although it meant that Mrs. Crane was to be taxed on a total gain of approximately $23,500 despite the fact that all she realized on the sale was cash of $2,500.

Later on in the year the Tax Court issued two decisions which seemed to stem directly or indirectly from the rationale of the Crane decision. They held that a taxable gain to the mortgagor resulted when, upon a foreclosure sale, the mortgage exceeded the adjusted basis of the property surrendered. (*R. O'Dell & Sons Co., Inc.*, 8 T.C., 1165; *Mendham Corporation,* 9 T.C., No. 48.) In the first case the taxpayer was directly liable on the bond and mortgage; in the latter decision the taxpayer corporation had acquired the property subject to the mortgage but without assuming it. In both cases the petitioners lost their property on foreclosure, received nothing in the process, yet were both subjected to tax.

*J. Robert Bazley* v. *Commissioner;* and *Adam A. Adams* v. *Commissioner* (331 U. S. 737).

In both cases petitioners owned stock of closely held corporations. As the result of recapitalizations they received new stock and bonds in exchange for their old stock. Both corporations had accumulated earnings available for dividend distributions. In both cases petitioners claimed exemption from tax on the basis that they were participants in tax-free recapitalizations under Sections 112(b)(3) and 112(g)(1)(E) of the Code.

The court held that any reorganization which acts as a vehicle for the distribution of earnings to stockholders will not be held to be tax-free under Section 112 or in the alternative, will be held partially taxable under Sections 112(c)(1) and (2). It is interesting to note that the question of business purpose was not considered significant in the Supreme Court decision although it was the focal point in the adverse decisions of the Circuit Court.

Practitioners awaited this decision with intense interest. A decision favorable to the taxpayers would have meant the end of the Section 102 problem. Whenever surplus cash was available, a corporation could recapitalize, and then disburse the cash in redeeming the bonds. Stockholders would pay a capital gains tax on a part of the proceeds under Section 117(f). Distribution of taxable dividends would have become a thing of the past.

Instead, it is now clear that the courts will not allow the utilization of the reorganization provisions of Section 112 for tax avoidance purposes, no matter how closely the taxpayer hews to the statutory line. They will be applied only in those cases where the exchange of securities results in "a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets."

*John P. McWilliams et. al.* v. *Commissioner* (331 U. S. 694).

Taxpayer sold securities at a loss. Simultaneously he ordered his broker to purchase the identical number of shares of the same stock for the account of his wife's estate. Thus he endeavored to establish tax losses without giving up family possession of the security. At the same time, the petitioner believed that he was avoiding the restrictions of Section 24(b) which disallows losses on sales of property made "directly or indirectly between members of a family."

The Supreme Court held that sales and purchases of the type described above, although consummated through an exchange with unknown third parties, nevertheless represented "indirect" sales between members of the family and hence deduction of the resultant losses was not permissible. It should be noted that the disallowance was based on the "family sale" and not the "wash sale" rule. Thus, not only was the loss disallowed as a deduction but the family was left with the new and lower cost basis.

**Family Partnerships**

The principles of the now famous *Tower* and *Lusthaus* decisions have been imprinted indelibly in the minds of all tax practitioners. The Supreme Court held that the questioned member of a family partnership must contribute either vital services or original capital in order to be sustained as a valid partner. Although the mere repetition of the *Tower* and *Lusthaus* conclusions may not seem warranted at this late date, a study of their effect on 1947 family partnership decisions should be of interest.

Of 44 Tax Court decisions issued in 1947, dealing with family partnerships, 32 were unfavorable to the taxpayer, i.e., more than 70% of the total. Of the remaining twelve cases, ten involved partnerships wherein all of the members contributed original capital and/or vital services. Based upon the facts pre-

sented, these partnerships should never have been questioned by the Department, let alone litigated. That the taxpayers were required to go to the Tax Court for relief indicates fully the vigor of the Department's assault upon family business arrangements.

The remaining two cases are of special interest and warrant individual consideration. In the first, the family arrangement consisted of a father and trusts for his two minor children. The mother and not the father was the settlor. The corpus of the trusts consisted of the mother's interest in the business which apparently emanated from capital originating with her. The Tax Court held that if the mother had invested her business interest in the partnership, she would have been recognized as a valid partner. "She chose instead to allow her two minor daughters to participate in the partnership business through trusts created by her for their benefit." This, the Tax Court permitted, giving rise to the hope that the subdivision of the partnership interest of an inactive but valid partner would be recognized. *Selma E. Goerlich et al.* v. *Commissioner,* Tax Court Memo Decision, Dockets Nos. 6195 and 6196, January 22, 1947.

In the other case to be considered, the Tax Court surprised most practitioners by recognizing the validity of a partnership consisting of the taxpayer, his wife and sister. Taxpayer was an active member of a partnership. In 1940, incorporation was contemplated. Taxpayer offered sotck in the proposed corporation to his wife and sister in exchange for some other securities which he had conveyed to them by way of completed gifts in 1937. The plans for incorporation fell through and instead, a new partnership was formed. Taxpayer's 50% interest was subdivided and an 11% interest each was assigned to his wife and sister for the same previously described consideration. The Court concluded that there was no element of gift involved in the transfer of partnership interests to the wife and sister and hence recognized the resulting partnership as valid. *S. E. Boozer* v. *Commissioner,* Tax Court Memo Decision, Docket No. 9297, August 28, 1947.

Would the decision in this case have been the same if the 1937 gift had been made in the form of cash instead of securities? Would the Tax Court nevertheless have ruled favorably if the special circumstances involving the contemplated incorporation had not existed? Unless these questions can be considered as answered in the affirmative, this decision must remain limited in its scope to the facts of the case. The writer believes that tax practitioners as yet cannot rely too heavily on this ruling although it has already been cited favorably in a Circuit Court decision.

Sixteen decisions involving the family partnership issue were released during 1947 by the various Circuit Courts of Appeal. Only 4 were favorable to the taxpayer and in one of these, the questioned partner rendered vital services. The other 3 favorable decisions will be considered in detail.

Where the partnership interests of petitioner's wife and two children were acquired not from himself but from his brothers who were active partners, the principles of *Tower* and *Lusthaus* were deemed inapplicable. *Ed. Dubinsky Durwood et al.* v. *Commissioner,* C.C.A. 8, February 6, 1947.

The second case is of wider import and tax practitioners are eagerly watching to see whether the Department will take this case to the Supreme Court and whether other Courts will take note of this decision. The facts briefly stated are as follows:

(a) In 1937, taxpayer conveyed stock in a closely held corporation to his wife, two sons and two daughters. All of these individuals at various times rendered some services to said corporation.

(b) Additional transfers by petitioner and his wife to the four children were made in 1938, 1939, and 1940.

(c) In 1940, the corporation was dissolved and the stockholders were constituted partners in a successor partnership.

The Tax Court recognized the sons who were active in the business as valid partners, but declined to acknowledge the validity of the partnership interests of petitioner's wife and daughters.

The Circut Court overruled the lower body and held that:

(a) The various conveyances of stock were valid and complete albeit informal in nature.

(b) The services of both the wife and daughters contributed to the development of the business "in substantial measure."

(c) At the time of conveyance of stock, no partnership was contemplated and hence, ulterior motives cannot be read into the gifts.

On the basis of the foregoing, petitioner's wife and two daughters, as well as his sons, were all accepted as bona fide members of a partnership. *Howard B. Lawton et al.* v. *Commissioner,* C.C.A.-6, November 24, 1947.

The last favorable Circuit Court decision is the case of *T. T. Simmons* v. *Commissioner,* C.C.A. (5), November 4, 1947. The court held that none of the partnership income could be taxed to the husband after he had made an outright and completed gift to his wife of his *entire* interest in the business. The Court considered this situation different from the usual one, wherein the husband merely splits the ownership of his interest with his wife but continues in control of the business.

One cannot leave the field of family partnership litigations without noting three District Court cases decided in 1947 sustaining the taxpayers. Disregarding the rationale of the *Tower* and *Lusthaus* decisions, the jury in the first two cases and the judge in the last recognized the validity of the family arrangements before them. *Knott* v. *Allen*—D. C., Georgia, January 15, 1947; *Mallory* v. *Allen*—D. C., Georgia, November 13, 1947; *Schepps* v. *Arnold*—D. C., Texas, June 9, 1947.

Although these three decisions are not the final word on the issue, not even of the specific cases decided, neverthe--less, they certainly indicate that tax practitioners must constantly consider the advisability of trying their family partnership cases in the District Courts instead of before the Tax Court.

**Tenants by the Entirety**

In this era of consistent judicial condemnation of family partnerships, one views with wonder and possible envy, the 1947 cases upholding the validity of divisions of income between husband and wife as tenants by the entirety.

In one decision the Tax Court condemned a family partnership between husband and wife while, at the same time, accepting the equal division of profits from the sales of property held as tenants by the entirety under the law of the State of Oregon. *Edwin F. Sandberg,* 8 T.C. 423, February 27, 1947.

In prior years, the effectiveness of state laws concerning tenants by the entirety in dividing family income was upheld for Pennsylvania, Michigan and Florida. *George K. Brennan,* 4 T.C. 1260; *Paul G. Greene,* 7 T.C. 142; and I.T. 3235, CB 1938-2, p. 160. In Pennsylvania this form of ownership extends to personal property as well as realty.

There are, of course, limitations to the generosity of the courts in these matters of joint ownership, raised to prevent abuse:

(a) The facts of ownership must be clearly established. *Ben Schwayder,* Tax Court Memo Decision, Docket No. 4462, March 31, 1947.

(b) State law restrictions must be observed. Thus in certain states, common law prevails, and requires the taxing of the entire income to the husband despite the existence of joint ownership. North Carolina and Massachusetts are examples of such states. I.T. 3878—1947.

(c) Losses must be divided as well as gains. *Walter G. Morley* v. *Commissioner,* 8 T.C., 904.

(d) Where tax evasion is the sole motive, the legalities of the family property rights will be set aside. *E. M. Godson,* Tax Court Memo Decision, Docket No. 4913, July 24, 1946.

**Section 102 Penalty Surtax**

Tax practitioners were alerted for a scheduled Treasury Department onslaught on corporations deemed to be improperly accumulating surplus by the inclusions of the new question #8 on page 3 of the 1946 Form 1120. This question requested reasons for failure to distribute at least 70% of the net income after all surplus charges. Because of this renewed interest in Section 102, all court decisions affecting this code section are worthy of study.

The most searching court analysis of the applicability of the Section 102 penalty surtax came in the adverse District Court decision, *World Publishing Company* v. *U. S.,* Northern District of Oklahoma, May 16, 1947. The following observations were noted by the writer in his original perusal of the case:

(a) Petitioner was not an investment company but an active business concern, a publishing corporation.

(b) Bona fide plans for expansion in plant and equipment evidenced by purchase contracts were submitted and accepted by the court. Only the war and equipment shortages prevented the fulfillment of these plans.

(c) The court observed that the expansion program could not be accomplished in a short period of time and hence would not require the full purchase price to be available in cash at any one time.

(d) A proposed venture into the radio broadcasting business was considered not a part of the needs of the business of publishing a newspaper.

(e) The court observed that the taxpayer: (1) had no debts other than normal operating ones; (2) had virtually no competition; (3) had no patents with limited life upon which its income was based; (4) had no serious labor problem; (5) had no war or peace conversion problem; and (6) was not dependent on foreign trade.

In arriving at its adverse decision, the Court observed that the immediacy of the need for funds for expansion was equally as important as the need itself in determining the propriety of accumulated earnings.

The harshness of this decision, however, is offset by the fact that it came from a lower court and that the Tax Court has ruled favorably in all of its 1947 Section 102 cases: *Lion Clothing Company* v. *Commissioner,* 8 T.C. 1181; *Kennedy Nameplate Company,* Tax Court Memo Decision—Docket No. 6695—May 29, 1947; *Gus Blass Company* v. *Commissioner,* 9 T.C., No. 3—July 8, 1947.

**War Losses**

Tax decisions during 1947 involving War Losses claimed under Section 127 of the Code dealt severely with the aspirations of the various petitioners. Generally speaking, the court found that the taxpayer had failed to establish, by weight of evidence, the cost of the assets lost and their existence and ownership as at the statutory date of loss. *Ernest Adler* v. *Commissioner,* 8 T.C. 726; *Eric H. Heckett* v. *Commissioner,* 8 T.C. 841; *Leon Block* v. *Commissioner,* Tax Court Memo Decision, Docket No. 6398—April 23, 1947; *Paul Saxl* v. *Commissioner,* Tax Court Memo Decision, Docket No. 7606—April 29, 1947; *Benjamin Abraham* v. *Commissioner,* 9 T.C. 222.

In both the *Heckett* and *Abraham* cases, partial allowances were allowed by the courts where it was felt that the taxpayer had established the required facts as to cost, ownership, and existence of securities in one case and real property in the other.

**Sale of Assets by Corporation or its Shareholders**

In the past few years, taxpayers have discovered that the sale of corporate assets at a profit, by the corporation itself, involved the imposition of a double tax, one upon the corporation and the other upon the stockholders when the corporation was liquidated. Attempts to avoid the apparent penalty by first liquidating the corporation and then selling the assets met with a serious setback in 1945 when the Supreme Court released its now famous *Court Holding Company* decision, 324 U. S. 331. The court held that where the facts

indicated that the stockholders were acting on behalf of the corporation in making the sale, the gain therefrom would be taxed first to the corporation. The issue in these cases will always resolve itself into a question of fact leading to the determination as to who was the actual seller, the corporation or the stockholders.

In the case of *Howell Turpentine Company* v. *Commissioner,* C.C.A. (5), June 4, 1947, the court found for the taxpayers and ruled that the stockholders and not the corporation had sold the property and incurred the taxable gain. Taxpayers with this problem or who are contemplating this type of transaction should study the facts and conclusions reflected in the above proceedings.

On the other hand, the corporation was deemed taxable as the true seller of its assets in the two following decisions: *Wichita Terminal Elevator Co.* v. *Commissioner,* C. C. A. (10)—May 12, 1947; *Benjamin Guiness* v. *U. S.,* U. S. Court of Claims—July 7, 1947. In the first instance, negotiations were initiated while the corporation was in existence and were conducted by a corporate officer and stockholder acting as "agent for the stockholders of the corporation." The final negotiations leading to the sale took place while the process of liquidation and dissolution was taking place. Dissolution was not completed when the written contract of sale was executed. On the basis of the foregoing, it was held that the negotiating officer was acting for the corporation in making the sale.

The facts of the second case are too complicated and specialized to warrant repetition. Suffice it to say that the liquidation and sale of the corporate assets were virtually simultaneous. Upon this basis the court chose to ignore the intervening step and considered the sale as consummated by the corporation.

### Option as Compensation

Petitioner, pursuant to an option given him by the president of the corporation of which the petitioner was an employee, elected to purchase stock from said corporate officer, at less than market value. The stock in question was stock of the employer corporation. Basing its opinion on the famous Supreme Court decision, *Commissioner* v. *Smith,* 324 U.S. 177, the Tax Court ruled that the petitioner had received an economic benefit from the exercise of the option; that said benefit was connected with and grew directly out of his employment; that the option was not a gift from the grantor. As a result, the petitioner was taxed on the difference between market and option value as additional compensation. *Wanda V. and C. A. Van Dusen* v. *Commissioner,* 8 T.C. 388.

In connection with this decision the writer raises the following questions:

(1) Does the president of the corporation secure a deduction equal in amount to the income taxed to the donee of the option?

(2) If not, does the corporation secure the deduction as compensation for services rendered?

(3) In measuring any gain or loss on the sale of stock, what amount should be included as sales proceeds, option price or market value?

### Cancellation of Indebtedness—Income

The Treasury Department has apparently never forgiven the Supreme Court for its *American Dental Co.* decision in which a gratuitous forgiveness of indebtedness was deemed a gift and not taxable income. It has fought an unrelenting battle, at first to defeat, and, failing this, to delimit its effect. In 1947, the Department lost further ground in this battle.

The Tax Court relied on the *American Dental Co.* decision in holding that no income was realized when a debt was cancelled for less than its face value as the result of direct negotiations between debtor and creditor. The fact that the agreement partially cancelling the debt also covered a sale of realty from the creditor to the taxpayer did not alter the decision in any way. The simultaneous purchase did not constitute consid-

eration. *National Ice and Cold Storage Co. of California,* Tax Court Memo Decision, Docket No. 7318, January 31, 1947.

Where a corporation repurchased its bonds at a discount directly from the holders of the bonds, the resultant discount will not be considered taxable income but will be viewed as a gift under the *American Dental Co.* rule. The taxpayer will not be required to adjust the basis of its assets as required by Section 22(b)(9) of the Code. The key to this decision is the direct negotiation between the debtor corporation and the bondholder. Where a corporation retires its bonds at a discount by purchases in the open market, the rule of this case will not apply. *Lewis F. Jacobson,* C.C.A. (7), December 5, 1947.

### Corporate Sales of Own Stock

In two cases decided during 1947, the courts held that the petitioner corporations were not dealing in their own stock as they would in the shares of another in the following instances:

(a) Sales of the stock were made by the corporation pursuant to an agreement of its stockholders that the shares would always be held solely by those responsible for its operation and in proportion to their contributions of services toward its success. *Rollins Burdick Hunter Co.* v. *Commissioner,* 9 T.C., 169.

(b) Sales of the stock were made by the corporation only to employees who demonstrated talent and ability and who contributed to the success of the business. Purchases of the stock were sometimes made from retiring stockholders. All purchases and sales were made at book value without any negotiation as to price. The original supply of the stock was donated to the corporation by stockholders to initiate a plan of rewarding outstanding employees. *Batten, Barton, Durstine & Osborne Inc.* v. *Commissioner,* 9 T.C., No. 63—September 25, 1947.

The Court found that no taxable gain had been incurred by the petitioners in both of these cases.

### Personal Holding Company—Penalty

The applicability of the negligence penalty for failure to file personal holding company returns under Section 291(a) of the Code has been the subject of considerable litigation during 1947. The conclusions of the court have not been crystal clear in their broad implications to other taxpayers, but it has seemed to the writer that a degree of liberalism and common sense has entered the scene.

The penalty was imposed in the case of *Orient Investment & Finance Company* v. *Commissioner,* Tax Court Memo Decision, Docket No. 7003, January 8, 1947, where taxpayer's principal officer claimed ignorance of the law and reliance upon the corporation's certified public accountants who maintained its records and prepared its returns. All of the factors of income and stock ownership fixing personal holding company status were available and apparent. The matter of filing such returns was apparently never considered or discussed. The court concluded that liability to file such returns was obvious and the "unexplained failure to do so" rendered the taxpayer liable for the statutory penalty. This view was sustained in *Palm Beach Trust Company* v. *Commissioner,* Tax Court Memo Decision, Docket No. 9569, November 28, 1947.

In four subsequent decisions rendered later in the year, the Courts held for the taxpayer and concluded that the Commissioner erred in imposing this penalty. Generally the factors leading to this favorable finding were the following:

(a) The nature of taxpayer's income were such as to render questions of personal holding company status unclear and disputable.

(b) Taxpayer *sought* the advice of reputable tax counsel, *discussed* the specific problem of personal holding company status, and *relied* upon the advice received. *Safety Tube Corporation* v. *Commissioner,* 8 T.C., 757; *Hatfried Inc., et. al.* v. *Commissioner,* C.C.A. (3)—June 11, 1947; *Frederick Smith Enterprise Co.,* Tax Court Memo Decision, Docket No. 11158—June 4, 1947; *Garrett Holding Corporation* v. *Commissioner,* Tax Court Memo Decision, Docket No. 9381—November 28, 1947.

In the *Hatfried* decision, taxpayer relied upon the incorrect advice of his *accountant* and the court commented on that fact in the following manner:

> "Previously we pointed out that the Treasury Department has long given sanction to the practice of taxpayers in enlisting the aid of accountants in the preparation of their tax returns. To this may be added that the Treasury Department regularly admits accountants to practice before it in representation of taxpayers and the Tax Court does the same.
>
> "To accord the status of 'experts' on the tax laws to accountants for representation purposes and then to hold that taxpayers who entrust to them the task of preparing their tax returns run the risk of paying heavy penalties should they err in the discharge of their assignment creates an absurd situation."

## "Substance and Not Form!"

The above shibboleth has become virtually a battle cry of the Department and the courts. Taxpayers have heard it to their dismay for many years and 1947 was no exception. This issue was raised in the following cases with varying results which should be of interest to many taxpayers and practitioners.

### *Assignment of Patents or Patent Rights*

Petitioner licensed several patents owned by himself to a corporation of which he owned 89% of the outstanding stock. Material royalties were to be paid and were, in fact, paid by the corporation pursuant to these licensing agreements. All agreements were subject to cancellation by either party without liability for damages or breach. After the agreements were executed, taxpayer assigned his rights under said agreements to his wife by way of gift. Thereafter taxpayer's wife reported all of the royalty income on her separate return.

The Tax Court attempted to tax these royalties to the petitioner ruling that he retained sufficient control over the income to be taxed thereon. The following were considered incidents of control:

(a) Petitioner controlled the licensee corporation by way of his ownership of 89% of the stock.

(b) Licensing agreements were subject to short-term cancellation rights by either party.

(c) Petitioner retained ownership of the patents.

The higher court, ruling in favor of the taxpayer, stated the following:

(a) The assignment of the royalty agreement rights constituted a gift of income-producing property and not a gift of income. The agreements and not the patents were deemed to be the "trees" of which the royalty income was the "fruit".

(b) Petitioner's powers to terminate agreement stemmed from his position as director of the licensee corporation. The court cannot base a decision upon conjectured or possible fraud by way of violation of petitioner's duties and authority as director.

*Joseph Sunnen* v. *Commissioner*, C.C.A. (8)—April 28, 1947.

In another case decided later in the year, an assignment of a royalty agreement to petitioner's wife was held sufficient to tax the resulting royalty income to the wife. Petitioner, as compensation for financing services rendered to a corporation, became entitled to receive a stipulated percent of royalties from the "Kodachrome" process. Petitioner assigned all his interest in such process to his wife. It was held by the Tax Court that the royalties received by the wife were not taxable to the petitioner. *Lewis L. Strauss* v. *Commissioner,* 8 T.C., 1058.

In both of these cases,- the courts were convinced that substance and form coincided and that the transactions were, in fact, what they purported to be. They did not find this to be the situation in the case of *Henry J. Taylor* v. *Commissioner,* Tax Court Memo Decision, Docket No. 8897, July 11, 1947. Here petitioner assigned a 25% interest in certain patents and royalties to his wife for no consideration, and pursuant to an oral agreement. The husband retained the unrestricted right to contract for, make, design and sell articles covered by the patents and to sub-license others. Royalties were paid

to the husband's agent and the wife drew upon the husband's account.

The court concluded, on the basis of the facts submitted, that the petitioner had not parted with any substantial interest in the income-producing property, and therefore, taxed all of the income to him. In effect the courts found no direct relationship between the purported form of the family arrangement and the realities thereof.

*Asssignment of Stock*

Taxpayer attempted to divide dividend income between himself and his wife on the ground that the stock in question was owned jointly as tenants by the entireties. The Tax Court found that the stock had been purchased by the petitioner in his own name, from his own earnings, and that he had possession and control over the stock at all times. Petitioner failed to prove the validity of his claims that his wife had contributed to the purchase and had actually received one-half of the dividends. *Ben Schwayder,* Tax Court Memo Decision, Docket No. 4462—March 31, 1947.

Petitioner purportedly sold securities to his son, who reported all dividend income thereafter. On the basis of the following factors, the court found that the sale was not bona fide and that the income from the securities must be taxed to the petitioner.

(1) Petitioner retained voting rights on stock.

(2) Stock remained pledged as collateral for petitioner's loan.

(3) Dividends on said stock were immediately loaned to petitioner.

*John F. Gouldman, Jr.,* Tax Court Memo Decision, Docket No. 11139, June 18, 1947.

In similar fashion the Court of Claims ruled that a purported gift of stock of a controlled corporation from petitioner to his wife was incomplete and the petitioner was taxed on dividend income therefrom. In deciding that petitioner had never surrendered dominion and control over the subject of the conveyance, the court relied on the following circumstances:

(a) Manual delivery of the stock certificates were never made.

(b) Wife never received notice of stockholder's meetings, never attended such meetings and never issued proxies for her stock.

(c) Dividends were never paid directly to stockholders but were credited to individual accounts on the books of the corporation. Transfers were made from one account to the other without apparent regard to their separate identity.

(d) Petitioner's wife agreed that petitioner might use her credit balance as he needed it and amounts standing to her account were occasionally transferred to his account.

(e) In personal financial statements issued by the petitioner, the stock, supposedly belonging to his wife, was included among his own assets.

*Roy B. Sewell* v. *United States,* U. S. Court of Claims, October 6, 1947.

**Miscellaneous Decisions**

Without attempting to arrange them in any particular order, either of occurrence or importance, the writer presents the following listing of miscellaneous court decisions which seem worthy of comment:

*Sales of Realty*

Loss on sale of former residence after being rented for a short period of time, held to be an ordinary loss from sale of property used in trade or business. A similar ruling was applied to inherited realty which was never occupied by the taxpayer. A loss on the sale of a dwelling used in taxpayer's business of renting properties was deemed to be an ordinary loss from property used in trade or business. *Daniel F. and Helen Norton* v. *Commissioner,* Tax Court Memo Decision, Docket No. 8670—December 31, 1946; *Arthur and Mary Scully* v. *Commissioner,* Tax Court Memo Decision, Docket No. 9072—February 11, 1947; *William H. Jamison* v. *Commissioner,* 8 T.C., 173.

On the other hand a Circuit Court ruled gains on sale of subdivided plots to be capital gains where the principal

owner, an attorney, held them for 13 years without improving or selling them. At that point the owners arranged for a builder to buy them at an agreed list price as he required them. The builder improved the plot, sold the house, arranged the financing, etc. The court ruled that the builder in this case was occupied in the trade or business of selling realty; the lawyer and his associates were merely liquidating their investment. Hence, the gains of the latter group are deemed capital gains. *John L. Fahs* v. *J. T. G. Crawford et. al.,* C.C.A. (5)—April 25, 1947.

*Inventories*

An arbitrary discount of 10% of inventory for shelf wear, outmoding fashions, market fluctuations, and handling damages, was not permitted where taxpayer could not prove that the resultant figures represented the lower of cost or market. *The Gem Jewelry Co., Inc.,* Tax Court Memo Decision, Docket No. 8921—January 13, 1947.

Where a taxpayer in mercantile business employed the cash basis for a long number of years, the court ruled that he was precluded from shifting to the accrual basis without the permission of the Commissioner. The method heretofore consistently employed by the taxpayer was held to fairly reflect income despite the fact that inventories were a material income-producing factor. *Maurice W. Simon* v. *Commissioner,* Tax Court, Memo Decision, Docket No. 8851—January 24, 1947.

Petitioner had consistently followed the practice in prior and current years of charging all purchases of bottles and cases to expense in the year of purchase. The Commissioner had apparently accepted this practice in prior years. Tax Court held that these bottles and cases were properly excluded from inventory at the close of the current taxable year. *Estate of Hugh Smith, Deceased* v. *Commissioner.* Tax Court Memo Decision. Docket No. 8425—March 31, 1947.

*Accounting Methods*

Petitioner billed for certain labor charges before performing them. At the close of each year, petitioner accrued and deducted the actual calculated cost of the labor required to perform the billed services. This procedure had been followed by the taxpayer consistently for a term of years. The court ruled, that the method adopted, correctly reflected income and permitted the deduction of the estimated cost of labor. *Towers Warehouses, Inc.,* Tax Court Memo Decision, Docket No. 7862—January 27, 1947.

In another case decided later in the year, the petitioner received payment for services to be performed in the future. These billings were not taken into income when billed and recevied, but were credited to a Deferred Income account called "Reserve for Handling Out". This account was reversed into income when the specified services were performed. The Tax Court ruled that the amount set aside in the Reserve must be included in gross income when payment was received. The Court distinguished this case from the aforementioned *"Towers Warehouses"* decision, by merely stating that the latter proceedings dealt with the question of a deduction and did not concern itself with an element of gross income. To the writer this seems to be a distinction without a difference. As between the two cases, however, the writer believes that the later case, although unfavorable, is sounder law and that the *Towers Warehouses* decision should not be too heavily relied upon. *Capital Warehouse Co., Inc.* v. *Com'r.,* 9 T.C.. No. 127—November 24, 1947.

Petitioner, a bus company, adopted the practice of including in taxable income, bus tickets collected for rides only. The Tax Court ruled that all proceeds of ticket sales, even advance tickets, must be reported in income where money was received by taxpayer without restriction as to disposition. *East Penn Transportation Co.* v. *Com'r.,*

Tax Court Memo Decision, Docket No. 10900—October 8, 1947.

*Non-Business Expenses*

Petitioner was sued as Administrator of an Estate for mismanagement. In order to avoid further litigation, taxpayer paid a sum of money to the suing beneficiaries. This settlement payment together with the legal fees paid in connection therewith were permitted by the court to be deducted as non-business expenses under Section 23(a)(2) of the Code. They were considered expenses in connection with the production of income notwithstanding the fact that petitioner, pursuant to the terms of the settlement, received no income as Administrator. *Hyman Y. Josephs* v. *Commissioner,* 8 T.C. 583.

Dividends paid on stock borrowed to cover short sales were held deductible as non-business expenses and were not considered reduction of sales proceeds or additions to cost of securities sold. *Commissioner* v. *Norbert H. Wiesler,* C.C.A. (6)—June 3, 1947; *Commissioner* v. *F. A. Wilson,* C.C.A. (9)—September 15, 1947. Since the Second and Third Circuits disagree, this issue will probably be taken to the Supreme Court.

*Non-Deductible Losses*

Section 24(b)(1)(B) disallows losses on sales of property between corporations and "individuals" owning a majority of the stock of the corporation. The Tax Court ruled that the term "individual", for the purposes of this Section of the Code, did not include partnerships. Hence, where a partnership, owning 72% of the stock of a corporation incurred a loss on the conveyance of property to said corporation, the courts held the loss deductible. *George Whitney et al.* v. *Commissioner,* 8 T.C. 1019.

*Compensation*

Bonuses paid to partnership employees from the personal funds of a partner held deductible by the individual partner as long as they satisfied all the other qualifications of compensation as to reasonableness, etc. The court distinguished the situation from the one where the expenses of a corporation are paid by an officer. In the latter instance no deduction was permitted. *Andrew Siarto,* Tax Court Memo Decision, Docket No. 4021—January 7, 1947.

The Tax Court sustained the disallowance of a portion of a salary paid by a partnership to its bookkeeper as unreasonable. The bookkeeper in question was not in any way related to either of the partners. Unreasonable compensation cases are not of themselves unusual. This case, however, interested the writer because of the questions it raised:

(a) Since employer was not a corporation, disallowed compensation cannot be deemed a dividend. Will it be considered a gift subject to Gift Tax?

(b) If a gift, can recipient recover the income taxes paid thereon?

*James V. and Vincent F. Patton,* Tax Court Memo Decision, Docket Nos. 10275-6, April 30, 1947.

# The Tax Executive—His Place in Management

*By* X. Bender Tansill, C.P.A.

The economic influences which govern our modern mode of living are vast and complex. Those tremendous expenditures of wealth which helped this nation to stave off defeat and slavery in World War II have placed the mantle of taxation upon our shoulders for generations to come. Costs of operating government today—federal, state, municipal—have increased tenfold in the last few decades. New sources of revenue are the ever-present subject of research by taxing authorities.

Sagacious corporate management, knowing full well the necessity of meeting modern business needs with highly trained specialists, has seen fit to establish its tax executives in a vital rôle in its directing council. Many large corporations have placed their tax managers in corporate positions of importance and others have elevated the position of tax executive or tax manager to that of equal importance with the treasurer and the controller. The General Foods Corporation is a notable example of this manner of dealing with the situation. In its "G. F. Stockholders News Letter" of January 2, 1947, (Volume 7, Number 1), it set forth an organization chart showing the grouping of its financial executives. The financial vice-president of the corporation is shown as the head of this coterie, with the "tax manager", the controller and the treasurer; each of equal importance and independent of each other, answerable directly to the financial vice-president, in the next lower echelon.

The tax executive holds a unique position in corporate management. In the recent past, tax executives of many of the largest corporations have banded themselves together and have organized an institute of tax men, known as the Tax Executives Institute. These tax men have gained the confidence and respect of both the federal and state tax administrators. The annual conferences of the Institute have been very productive in bringing about a better understanding of tax problems and their solution as between the federal and state tax authorities and corporate tax executives.

It is very interesting to note, from the membership rolls of this association, that most of these tax men and their assistants are accountants. This would seem to indicate that the acountant, more than anyone else, is the one who is most interested in the matter of taxes and the preparation of tax returns and other tax data for the federal and the state governments alike. Moreover, it should be mentioned in passing that the vast majority of the men who examine tax returns, conduct hearings, and make most of the decisions thereon, for both the federal and the state governments, are accountants.

X. Bender Tansill, C.P.A., holds certificates from New York, New Jersey, Indiana and Michigan. He is a member of our Society and of the American Institute of Accountants. He was graduated from the Pace Institute in 1922.

During World War II, he was a Commander, Supply Corps, USNR, and was the Officer-in-Charge of all Cost Inspection (USN) activities in Detroit, Michigan.

He has been in accounting practice since 1919 and his diversified experience includes public accounting, corporate accounting and governmental accounting (income tax unit) practice.

### Need for Tax Men

One of the important needs in business today is for more trained tax men. The repeal of the excess profits tax by the federal government has brought into clearer focus the state tax panorama. During the War the state tax problem was of minor importance as it represented a final cost to corporate industry of fifteen and a half cents to twenty-eight cents, approximately, on the dollar. With the rescinding of the excess profits tax, the final cost of state taxes to corporations, in general, now ranges from sixty-two cents to seventy-nine cents on the dollar. For example, in the case of a corporation which has a taxable net income for federal tax purposes of $50,000 or more, every dollar of state tax paid represents a deduction against taxable net income (federal) of thirty-eight per cent. Accordingly, only thirty-eight cents of the state tax dollar is, in effect, mitigated or offset by the federal taxes, normal and surtax, leaving an actual loss of sixty-two cents for each dollar of state taxes paid.

Thirty or more of our states impose taxes on or measured by the net income of corporations. The tax laws of most of the states are dissimilar and the apportionment formulae in use by them run the gamut of bases. Corporations which are registered to do business in many states are required to have extensive tax libraries in order to cope with the situation.

Controllers and treasurers, faced with the mighty task of merely keeping abreast of current developments in finance, costs, accounting and auditing procedures, the furthering of internal control, the preparation of accounting manuals and the like, are finding it more and more difficult to try to keep up with the kaleidoscopic changes in federal and state taxing requirements. Myriad court decisions, regulations, rulings, articles, tax services, alone are enough to keep one engaged full time in reading and trying to interpret them. The tax executive, more than ever before, is a very necessary adjunct to the successful operation of neoteric business.

It is not enough to be possessed of a tax department and tax executives. The top stratum of corporate officials should come to realize the necessity of referring proposed financial ventures or commercial transactions to tax executives in order that any tax implications contained therein may be weighed in the balance and proper consideration be given to them. Only too often unnecessary risks and hazards are encountered or brought to light after a deal or trade is made which could have been avoided if the tax consequences had been reviewed in advance. Quite frequently a great mass of unnecessary work and careful research are required to try to circumvent an unfavorable tax outcome, of an otherwise simple solution.

### Tax Training

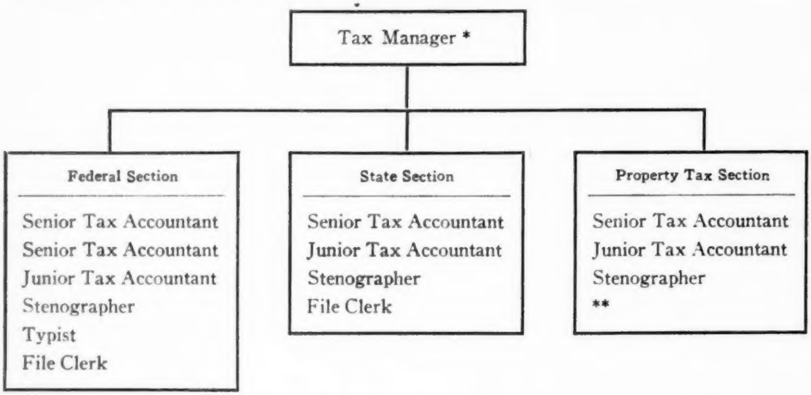
The matter of training the tax accountant is of utmost importance. Many colleges have inaugurated courses in taxes but, to date, there has not been enough emphasis placed upon this subject. Some universities have recently organized specialized tax sessions in some of the more important phases of taxation, yet this is only a beginning. Up to the present time most tax men have had to acquire their tax training the hard way—by arduous work and toilsome research—without the benefit of college courses in taxation. The majority of them have long since been graduated from college and have had years of service with the taxing branches of the government or in the tax departments of private industry or public accounting firms.

### Organization of the Corporate Tax Department

The organization of a corporate tax department has not been standardized as yet. There appear to be two schools of thought regarding the proper arrangement and structure thereof in the case of large corporations which have many affiliated companies. One holds

that there should be a complete separation of work as between the federal section and the state section whereas the other contends that the federal and state sections should be interchangeable. The former believes that the senior tax accountants in the federal section should busy themselves with federal matters only and those in the state section should only handle state matters, whereas the latter feels that the senior tax accountants should have their work assigned to them on a company basis so that both federal and state tax matters for a particular company would be handled by the same individual.

A typical organization chart of a corporate tax department for a larger type corporation with many affiliates, is set forth below:




* This includes a secretary for the Tax Manager.

** File clerks for federal and state sections will take care of the files of the property tax section.

Note: The stenographers will be used interchangeably as between the federal, state and property tax sections according to the work load.

In an organizational plan such as is shown above, many specialized tax tasks can be provided for. As an example, one of the senior tax accountants in the federal section may be assigned to the work regarding the foreign tax needs of the department.

## Tax Working Papers and Files

Much importance should be placed upon the working papers of a tax department. Usually several years elapse after a federal tax return has been filed before it is audited in the field by a a revenue agent. Therefore, nothing should be left to memory or guesswork. Everything pertaining to a tax return must be carefully recorded and documented in order that a proper and expeditious showing of all the facts may be made whenever the corporate tax deparment is called on to produce its records. There is nothing quite so convincing to a revenue agent, and to corporate management as well, as a ready and direct reply regarding the information which supports tax returns and other tax data.

A tax department's files should be so set up that the information therein contained is readily available. It is a good policy to file each tax year separately and the file of each year should be divided into several sections. One of these sections should be for documents—revenue agent's reports, A-2 letters, waivers, claims, originals of letters granting extensions, taxpayer's protests, and the like — and should be known as the document file for that year; another section should be for the completely typed copy of the tax return with all the schedules and necessary papers attached thereto (this copy

should be conformed to the original return); a third section should contain the working papers and the working copy of the tax return and schedules; and a fourth section should be devoted to correspondence. It is advisable to keep a running log or account, in the document section of the file, regarding everything that has happened during the year. Recorded in this log should be such information as the date the return was filed, the payment dates and amounts of each installment of tax, dates waivers and claims were filed together with any other pertinent data thereon, and similar information. The procedure outlined above can be extended or expanded to cover each separate company in those instances where there are affiliated corporations involved. Under certain circumstances it may be desirable to have special additional files to cover depreciation, carry-back losses and kindred subjects.

### Conclusion

Benjamin Franklin has been quoted as having said that "in this world nothing is certain but death and taxes." The wisdom of this realism, uttered over a century and a half ago, stands out with even greater import today. Therefore, those who are prudent will see to it that they are equipped with the best available tax information and guidance. Tax executives and corporate tax departments should be the first consideration in these circumstances. In this day and age it is highly important for taxpayers to be well versed in taxation. Ignorance of the law is no excuse. It may, and very often does, cost one very heavily in taxes.

One may *avoid* a tax but he may not *evade* it. In *George D. Horning* v. *District of Columbia* (254 U. S. 135), Justice Holmes of the United States Supreme Court aptly stated the difference between "avoidance" and "evasion" as follows:

> "It may be assumed that he intended not to break the law, but only to get as near to the line as he could, which he had a right to do; but if the conduct described crossed the line, the fact that he desired to keep within it will not help him. It means only that he misconceived the law."

And in a somewhat similar vein, Judge Learned Hand said:

> "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that patttern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." (*Helvering* v. *Gregory*, CCA-2, 69 F. (2d) 809).

However, where tax avoidance is an issue, there is a qualifying factor which must be considered, i. e., in transactions which have been entered into with a view to effecting an income tax saving, "a business purpose" must be established. (*Gregory* v. *Helvering*, 293 U. S. 465).

# Accounting Problems of Operating Airlines

*By* Leo R. Gilleran, C.P.A.

The title of this address might better be accounting problems applicable to operating airlines because I do recognize that fundamentally there are no new accounting problems and it is only the application of accounting which makes the problem.

### Factors Basic to Accounting Problems

There are two major factors that cause the accounting problems of operating airlines to be different from those of other industries. The first is that the airlines operate in many scattered locations and the other factor is that the airline industry is comparatively young and small with constant technical changes and, as a result, procedures have had a hard time keeping up with the industry. In order to understand the accounting problems, it is necessary to visualize the physical setup of an operating airline. It is made up of major and minor line stations, some of which are terminal and junction points, some of which are not much more than a fuel stop; many ticket offices of varying sizes; at least one major overhaul base; a general headquarters; and often divisional and regional headquarters. Since accounting forms originate at all of these points, it is very essential that these people be given easy-to-read and detailed accounting procedures which they will be able to follow.


Leo R. Gilleran, C.P.A., has been a member of the American Institute of Accountants since 1941, and was a member of the Illinois Society of C.P.A's., while engaged in public accounting in Chicago with Allen R. Smart & Co. He was with Boeing Airplane Company in Wichita, Kansas, during the war, and was a charter member of the Wichita Chapter of N.A.C.A. He is now Controller of Trans World Airline, Inc., which company he joined in 1945.



This paper was presented by him on October 21, 1947, at the regular meeting of the Denver Chapter of N.A.C.A.


### Uniform System of Accounts

Unlike many other industries, the airlines are told what type of accounting structure they must follow. The fundamental account structure is prescribed by the Civil Aeronautics Board in its "Uniform System of Accounts for Air Carriers." By having to follow a uniform system of accounts, additional problems are created in that in many instances this system will not furnish the necessary information for top management properly to control the costs. The only distinct advantage that might be offered for a uniform system of accounts is that the industry does have a tool by which it can compare the relative efficiency of one carrier with another. However, even this cannot be considered as a positive comparison because the uniform system of accounts is in many instances interpreted differently by every carrier, mostly because of different types of organization. As all of you well know, it is possible to place ten accountants at a table, give them all the same definition, and ask for their interpretations of that definition, and you might find as many as ten different interpretations. In addition to prescribing the accounts which we should use, we are also required to furnish on a monthly, quarterly, and annual basis detailed financial and operating statistics to the CAB. The necessary reports and statistics required by top management for proper control can not always be obtained from the statistics which we must furnish to the CAB. We must, therefore, further segregate accounts by sub-accounts and

departments in order to get the information required.

### Accounting Objectives

The overall aim of the accounting department is to produce financial and cost statements within a reasonable time after the end of a given period to conform with CAB requirements and requirements of management. The reports, statistics, etc., furnished to management are of a nature required for adequate control of operations and costs of other functions. These reports, etc., are of a more detailed nature and constantly require analyses to determine the efficiency or inefficiency of a particular operation or function. Accounting can only justify its existence when it has furnished management with tools adequate for proper control. To portray properly the many accounting problems in an airline, let us take a look at the major accounting functions.

### Revenue Accounting

I believe one of the most difficult specific account problems in an airline is that of revenue accounting. An airline revenue and receivables section has many varied and unusual aspects from an accounting standpoint. It is primarily responsible for all accounting, auditing, collection, and credit activities required in connection with passenger and cargo sales, and related matters. Although procedures are constantly being changed, principally to keep up with the tremendous increase in volume, it is rather difficult to change the detailed accounting control and move to a system of accounting by exception. Since the airlines are selling a service, the only physical items representing revenue are the tickets and the waybills. The accounting controls must be built around these two items. This problem is further complicated by the interchange of tickets and shipments between airlines. It is not uncommon for the sale of a single ticket to result in accounting entries for revenue, expense, receivables, and payables accounts for three or four airlines.

### Unearned Revenue

Another major accounting problem having to do with revenue is the determination of the unearned revenue at the end of an accounting period mainly caused by different basic rate areas, equalizing of fares between points, etc. Where heretofore there had been a rather simple operation with relatively small volume of individual tickets to handle, it has now grown to the point where the computation of unearned revenue must be on a statistical formula basis. Incidental to the revenue problem is a large volume of accounts receivable occasioned principally by the Air Travel Plan. This Plan was designed to permit individuals and corporations having approved credit ratings to charge ticket purchases. All of the major airlines are parties to the Air Travel Plan agreement and since each issue credit cards good on any airline, a considerable volume of interline accounting is created.

### Mail Rate Pay

A major problem of revenue for all airlines which, although really a financial rather than an accounting problem and also a very controversial subject, is that of the mail rate pay. This problem is currently in and out of newspapers, committees, Congress, and any place where two airline people get together. A basic question in this problem, when the rate is to be on a compensatory rather than a need basis, is whether two hundred pounds of passenger costs more or less to carry than two hundred pounds of mail, express or freight, or whether they should be considered by-products. I certainly do not have the answer to this question, and if any of you could answer it or set forth any ideas on it, I am quite sure the airlines would be very grateful. Many of you have probably heard or read that the government is subsidizing the airlines through mail pay, but we do not agree that mail pay we receive from the government is a subsidy. In this regard, I would like to quote a paragraph from the October 1, 1947, issue of American Aviation included in an editorial writ-

ten by Wayne W. Parrish, editor and publisher of that magazine:

> "The next person who gives out a statement to the papers or writes a newspaper article or makes a speech mentioning the word 'subsidy' for trans-Atlantic service should be made to stand in the public square at high noon and read the dictionary definition of the word for one solid hour. Subsidy is NOT a fair payment for services rendered. Subsidy is a gift or a grant for activities or services deemed advantageous to the public. The trans-Atlantic airlines would be receiving subsidy if they were paid amounts over and above the stamp revenues received by the Post Office and over and above the Post Office overhead, but when they receive 32% (TWA only receives 28%) or less of the stamp revenue, and operate in the red because of it, they are being severely and shamefully short changed."

I believe that Mr. Parrish, in his article, brings out some interesting figures:

> "For the first six months of 1947, the three American flag carriers, American Overseas, Pan American and Trans-World, carried 1,040,000 pounds of U. S. mail from this country to Europe. For carrying this mail the carriers received less than two million dollars, roughly as follows: AOA — \$600,000, PAA — \$500,000 and TWA — \$890,000. But the Post Office Department took in about six and a quarter million dollars for the sale of stamps for this 1,040,000 pounds of mail—at a conservative estimate."

## Payment of Bills

The next complex problem that we run into is the payment of bills. As you can well realize, when an airline reaches around the world, through several countries, states and locations, this problem really becomes difficult. Basically, the payment of bills is a simple operation consisting of predetermined commitment authorities combined with subsidiary records designed to permit maturity payment or other organized disbursements. The problem is to pay bills at these geographically remote operational points and maintain a standard of internal control. I believe that the payments can be classified in three major groups: (1) local recurring bills, (2) miscellaneous service and supply bills, (3) major payments in relief of accrued liabilities. In the case of local recurring items such as heat, light, water, rent, etc. the time element required to pay these items is an important factor. To preclude delays in payment which often result in penalties, each local office is given sufficient authority to pay these bills with numerically controlled local office drafts.

The volume of miscellaneous service and supply items and the small monetary significance of each item does not warrant having these items transmitted to the home office for payment. There is established in each location petty cash funds, through which this type of expenditure is paid. The petty cash funds, of course, are controlled and audited through the home office.

The last group of payments which must be made representing major purchases and relief of accrued liabilities is processed only through the home office and is predicated on formal commitment instruments. Generally speaking, these items are handled in a manner similar to any other industry.

In processing these three groups of payables we again run into difficulty of complex accounting distribution which is necessary to satisfy the CAB and our own requirements.

The payment of bills incurred for operations outside the limits of the United States is similar in character to local payments. However, as you can well realize, in every country, state, city or municipality, we become involved in peculiar tax laws, very unstable currencies, and foreign government policies which do not follow any standard pattern. In addition, where local currencies are accepted by us, we must use as much as possible to pay local liabilities. So you see that the simple expedient of paying a bill is rather difficult in an airline extending its service throughout the world.

## Payroll Problems

The payroll problems emphasized by the necessity of meeting established pay days at wide spread locations and the necessity of including on all payrolls

new employees and employees transferred during the period, including consideration of numerous tax problems, accounts principally for the complexity of the payroll operations. Each location must receive pay checks on predetermined pay days. To accomplish such schedules it is essential that payroll functions be thoroughly organized to the extent that such requirements are anticipated. In this respect various state labor laws controlling the date of payment to employees must be given full consideration. Union agreements, of which we have quite a variety, and the complexities usually associated with such matters present problems that are not readily resolved and frequently are involved to the extent that many interpretations are necessary before accurate payments can be made. Payment to terminated employees in a number of states is controlled by state law. In such instances special handling must be arranged. Quite frequently this is handled locally by payment through local office draft as authorized by the payroll section. Because of far flung operations proper accounting distribution requires accurate information or description of functions performed.

American nationals employed in foreign lands generally desire that applicable checks in American dollars be deposited to their credit in banks designated by them, which requires special handling. In connection with payments to American nationals in foreign countries, payroll processes are further involved to the extent that base salaries are increased for living allowances related to the particular area in which they work, plus foreign increment, an arbitrary amount allowed for foreign service. This living allowance varies at each location, resulting in additional problems when employees transfer from one station to another in foreign lands.

Payroll taxes are an involved function to the extent that the tax laws of the various countries, states, and even cities differ. In addition to the normal Federal withholding tax, FOASI and FUI and state and city taxes ordinarily recognized as a part of regular payroll procedures, we are involved with foreign taxes that, although comparable, are not always based on the factors with which payroll problems are ordinarily associated.

Deductions from earnings for equipment required for proper performance of duties has been the policy of the company in that uniforms and items of a like nature are paid for by the company and reimbursed through salary deduction. This has involved considerable volume of detail.

Transfer of personnel between states and countries also requires complex tax computations and reports.

### Property and Equipment Accounts

The evaluation of property and equipment is a difficult accounting problem for airlines. Although depreciation in a normal sense affects the office equipment, building, building improvements, shop machinery, etc., as in any other industry, the rapid changes in plane design and performance make both the aircraft and spare parts the real accounting problem in determining the proper life of these assets. Although the CAB Manual of Accounts determines by definition the classification and grouping of property and equipment, it does not specify depreciation rates. The write-off on aircraft and spare parts is truly an obsolescence item aggravated at times by rulings of the Civil Aeronautics Administration. For example, if the airlines did not put in certain "fire fixes" by next spring they could not continue with the DC-3 in scheduled commercial operations. Related to this problem of life expectancy is the floating nature of a large part of the property and equipment which requires a considerable amount of property accounting by location, not only to account for the physical assets of the company, but to handle such problems as property taxes and insurance.

The problem of proper maintenance of inventory records and proper record-

ing of material costs causes many a headache throughout the system. When one looks at an airplane from the outside, he cannot visualize the enormous number of parts that go to make up that airplane. We have approximately 45,000 items that must be carried in inventory in order to maintain the schedules and accomplish proper maintenance. It is necessary to determine specific quantities of these various items that must be maintained at certain locations. The volume of paper work necessary to maintain proper material control is tremendous. Most of the inventory that is stocked at the various locations is shipped from the main stores for requisitioning as needed. One of the problems in inventory is that of attempting to place a value on an item once it has been requisitioned and charged to expense, then repaired and returned to inventory.

In airline operations, it is necessary to maintain a specific quantity of particular items with minimums established by the CAA. Keeping in mind the rapid changing picture of airplane design and performance, the airlines are put in a very peculiar position in that the CAB Manual does not provide for obsolescence reserves for the high inventory values which they are required to maintain.

There are many items in inventory which carry warranties. These warranties are established between the airlines and the vendors on a basis of flying hours that the item might be expected to last. If the item, for example, is set up for a life expectancy of 150 hours and because of circumstances beyond the operator's control it ceases to function properly after 75 hours, we theoretically may obtain a credit of 75 hours on that unit, or we may return the item, have it repaired to bring the life back to 150 hours for a fee to be determined by the vendor based on usage. This requires many detailed records of hours on the parts and considerable bookkeeping in setting up estimated charges and later clearing them out.

## Cost Accounting Problems

One of the major problems in which the Cost Section of an airline is involved is that of establishing a cost system whereby the requirements of the CAB are met and also the requirements for management are obtained. This factor coupled with the various types of maintenance bases which an airline operates has, in the past, caused many difficulties. There are three types of maintenance stations for each of which a cost system had to be devised. They are: (1) minor line station, (2) major maintenance base, (3) overhaul base. At the minor line stations the amount of maintenance performed on an aircraft is very nominal. The work is usually that which is commonly known as line service and does not require any detailed cost set up. The major line stations perform a major part of the routine operational checks to the aircraft as specified by CAA. At these points it is necessary to obtain more detailed cost so that management can know the cost for maintaining and performing the various operational checks by type of aircraft and by type of check to ascertain that the particular base is maintaining safety requirements, and at the same time the level of efficiency necessary for an economic operation. At an overhaul base the cost accounting problem for an airline is quite unique in that you may have ten separate manufacturing units performing various types of overhaul on all sorts of equipment. For example, you would have propeller, engine, accessory, radio and electric, fabric and upholstery, metal and carpenter shops, etc. In addition to these various shops the overhaul base usually has from one to four hangars which are used primarily for overall airplane overhaul and modification. In view of the various departments I have mentioned, you can readily see that each shop is practically an entity in itself and can be treated for cost control purposes as a manufacturing unit. Each shop has its own peculiar-

ities. Where one shop works on a propeller and all its component parts, another would work on fine instruments with parts so small they can barely be seen by the human eye. This difference you can well realize creates a real problem when you try to establish a cost system that will cover these varying items of production in a comparable manner for CAB and management purposes. The cost system at the overhaul base of necessity must be very detailed in order to measure the efficiency of every operation performed at the base regardless of type.

Many of the detailed cost functions at those locations where an accountant would not be justified must be performed by other employees through the use of detailed written procedures. The problem of accounting distribution also creates considerable discussion in the Cost Section of an airline where it is necessary to determine to which CAB account every item of material and labor dollar must be charged. Here again we have to interpret the CAB Manual to determine which account should be used.

## Machine Accounting

The machine accounting section of an airline is one that really hums with activity. As in the case of most other industries having an exceptionally large volume in their accounting department, it has been found desirable in the airline industry to handle the detail by use of the tabulating machines. Our volume presently involves punching 618,000 cards per month from which is developed information for 409 different statements, reports and other types of analyses. It will be readily understood that to operate a section handling so many cards and reports, etc., efficiently definite schedules must be established and adhered to. Any failure to meet the schedule due dates reflects all the way down the line as does any failure to get punching media to the tabulating section at the scheduled due date.

## General Ledger Accounting

The general accounting or ledger section of an airline is similar to that of any industry in that here all the data that has been compiled by all the other accounting sections is molded together for corporate purposes and financial statements and statistics as required by CAB and management. The major difference between this section in the airline industry as compared to other industries is that they are governed by the CAB as to the accounts which they must maintain. In addition to these accounts, they must of necessity maintain detailed sub-accounts further broken down by many departments and locations to provide data for management. We also have the problem of maintaining sufficient basic accounting records, often in a foreign language, to satisfy foreign government requirements.

## Miscellaneous Accounting Problems

In the miscellaneous categories of accounting problems are those having to do with the operation of food units and various joint operating agreements with other carriers. We operate a production kitchen where food is prepared and sent out to a number of food units, some of which also operate cafeterias and restaurants, all of which require a separate system of accounting to follow the cost and control the operations. We must also be able to lift from our accounts costs directly related to porter service at some points, communication service at other, air mail field post office maintenance and complete station costs where we have arrangements whereby charges are prorated between the carriers operating at that point or using the service. Real cost accounting comes into play in determining the basis for prorating the costs, particularly when you must satisfy big and little airlines operating different types and sizes of aircraft.

A real test of the sufficiency of detailed accounting distribution is in process for most airlines since we are all

applying for rate changes. In our particular instance we are currently involved in attempting to allocate both revenues and expenses over parts of our International group. This raises many of what are control questions in attempting to determine equitable formulas for the prorations. It is vital to the airlines that they have necessary basic information since it is used by the CAB to set airmail rates.

## Conclusion

In conclusion I would like again to direct your attention to the fact that most of the airline accounting problems emanate from the requirements of government agencies coupled with the fact that the industry is relatively young, having little or no precedent or historical data by which it might guide its course when defining policy or procedures to cover the ever changing conditions of a phenomenally fast growing industry. This growth is best illustrated by the increase in available seats from 7,200 at the end of 1945 to 17,300 at the end of 1946, with a projected increase by next spring to approximately 25,000, or an increase in a little over two years of 250%. This is increased even more by the much faster speed of the newer aircraft. At some future date when the development of aircraft has been stabilized to the extent that changes in operations, policy, equipment, etc. are less frequent, I believe that precedent and historical data will reduce the accounting problems of airlines to a more normal variety. This may be just a hope and related to the old story of the grass looking greener in the backyard of the fellow next door.

# Airport Accounting

*By* Joseph M. Cunningham, C.P.A.

Accounting for airports presents unusual problems primarily because the industry represents a unique partnership of government and business. This is the one industry which business wants the government to finance and to operate, as it is realized that only with governmental aid can air transportation be developed.

The airport industry is a large and rapidly growing one. At the present time it is roughly estimated that federal and local governments have over one billion dollars invested in terminal type airports or airports which have scheduled air service. The Federal government is now granting many millions in aid of local construction, and municipalities are expending many more to develop their airports.

Joseph M. Cunningham, C.P.A., has been a member of our Society since 1936 and is presently serving as a member of the Committee on Governmental Accounting. He is also a member of the American Institute of Accountants and of the Municipal Finance Officers' Association of the United States of which he was formerly the President.

Mr. Cunningham is a specialist in governmental and institutional systems installations. His lengthy and varied experience includes service as First Deputy Comptroller of the City of New York for seven years.

He has written extensively for many accounting periodicals including the Journal of Accountancy and the Airport Magazine. He recently participated in a major study of the methods of operation of airlines at airports, as well as their financial relationships with municipalities, on behalf of the Air Transport Association.

These fields will be utilized by a great variety of users. Both scheduled and non-scheduled airlines will use the airports; the fuel industry will supply gas and oil; individuals and corporations will land and store planes used in their business operations; private enterprises will operate restaurants, stores, shops and a hundred varieties of businesses; citizens flying for pleasure will land their planes; and the owners of the field will provide bus and taxi stands, and develop many other uses of the field's facilities.

As the terminal type airports are owned and operated mainly by municipal governments, airport accounts must be based on the practices and principles of governmental accounting. At the same time, a system designed solely along municipal lines would be inadequate properly to control and report the airport operations. A system therefore must be designed which will serve municipal needs, yet also provide data on the major commercial aspects of operations.

Since airports are constructed in the public interest, it is essential that each user should pay a fair share of the costs, and it is in this determination that the major problems of the accounting department arise.

A correct income account is, of course, the first consideration in any accounting for airports. Because of the fact that municipal accounting does not concern itself with the distinction between capital and income, I believe it is fair to say that there are not more than a half dozen terminal type airports in the country which have maintained accurate capital accounts and determined their true net income from year to year. There are very few which are in a position to do so today, although the Municipal Finance Officers' Association is making every effort to spread

the use of a standard system of airport accounting. The best municipal accountants are agreed that even within the limitations of local laws, an adequate system can be integrated with the municipality's accounts.

I referred above to the "net income" of airports, but to my knowledge no "net income" has been earned by any terminal type airport. Many report "net income" but such reports may and probably do omit interest on bonded indebtedness incurred for the airport, include no charge for work done by other city departments, make no accurate distinction between maintenance and capital costs, make no provision for the loss of tax revenue, on property taken over for airport use, and omit many other items which should be considered. Practically all large airports operate at a net loss, and the major financial worry of every airport operator is to break even.

In attempting to place his field on a self-supporting basis, the airport manager should have a set of accounts which will assist him in this effort. He should know the true cost of operating each section of his airport, and he should assess his charges on the users of each section so that, when the field approaches the capacity for which it was designed, it should operate without loss.

There are three natural physical divisions of an airport which provide the basis for collecting costs and assessing charges. This fact permits a simple distribution of expenses without an intricate allocation of time, materials or overhead. Such simplicity is essential, since all airport budgets are trimmed to rock-bottom by municipal councils. The three sections to which I refer are the field area, the hangar area and the terminal area.

The field area includes the land, improvements, runways and aprons. This area is used principally by the scheduled and non-scheduled airlines, the private flyer and the federal government. Accounts should be established which will accumulate the costs of operation of this section of the airport. Revenue accounts should also be provided which will show the revenues from that area. Statistics should be maintained to supplement the accounts so that the relative use of the field by the various types of users may be determined.

The second natural division of the airport is the hangar area. This area is used by the airlines, by express companies, by private flyers, by aeronautical repair and sales enterprises, and by flying schools. Accounts should be provided to record the expenses of this section of the airport, and revenue accounts to correspond.

The third section is the terminal area. This would include the terminal building and associated facilities. The terminal area has a multiplicity of uses from the ticketing of passengers to the sale of life insurance. It is the area in which lies the greatest possibility of increased revenues under good management, and accounts should be provided in complete detail for every type of revenue received.

Expenses which cannot be charged directly to any account in the above three sections are, in the main, administrative in nature and should be so classified.

A system of accounts designed on the basis outlined in the foregoing paragraphs will do much to aid the growth of air transportation. It will tell the local taxpayer exactly what the airport is doing. It will inform the airlines and other users of the needs of the airport, and show to all concerned the share they pay of the operating cost. It will aid the state and federal governments in determining their policy on national air transportation questions. It will give the airport manager much help in understanding and controlling his financial operations. In short, it will attempt to answer the many problems created by the unique nature of the airport industry.

# Computation of Interdependent Pennsylvania, New York and Federal Taxes

*By* BEDRICH F. SCHONBERGER, C.P.A.

THE computation of interdependent state and federal taxes based upon net income is often quite complicated in cases where two or more states are involved. The specific situation dealt with in this article is that of corporations doing business in both New York and Pennsylvania.

BEDRICH F. SCHONBERGER, C.P.A., has been a member of our Society since 1945. Graduated from the University of Prague with a degree of Doctor of Law, he was a practicing public accountant and tax consultant in Czechoslovakia from 1920 to 1939 and was accredited by Czech Courts as an Expert in Accountancy. He has written a book and a number of articles on tax law and procedure in Czechoslovakia.

He holds the M.S. degree from the School of Business, Columbia University, and has been associated with a prominent New York firm of C.P.A's. since 1943.

The state taxes to which such corporations are subject (the Pennsylvania Income Tax, New York Franchise Tax, and Pennsylvania Franchise Tax) are mutually interdependent.* The net income for New York Franchise Tax purposes must be determined by deducting the properly accrued Pennsylvania Income and Franchise Taxes; in computing the Pennsylvania Income Tax and the Federal Income Tax, accruals for all of the above state taxes are deductible; and, finally, the determination of the value of the capital stock, for the purpose of the Pennsylvania Franchise Tax, will be affected by the accrual for those state taxes as well as that for the Federal Income Tax.

The method suggested here includes two steps:

*First:* Each of the four unknown taxes is computed on a tentative basis.

*Second:* By means of a formula, the total of the three state taxes is computed; a work sheet produces the amount of each of the state taxes.

### Basic Computation

*Condensed Profit and Loss Statement*

| | | |
|---|---|---|
| Gross Profit | | $ 700,000 |
| Long-term capital gains: | | |
| from sale of stocks and bonds | $ 2,000 | |
| from sale of tangible property—Pa. | 7,000 | |
| from sale of tangible property—N. Y. | 3,000 | 12,000 |
| Interest received | | 500 |
| Dividends received | | 6,000 |
| Total | | $ 718,500 |
| Interest | $ 8,500 | |
| Pennsylvania income tax | unknown | |
| Pennsylvania franchise tax | unknown | |
| New York franchise tax | unknown | |
| Other expenses (inclusive of $20,000 of charitable contributions) | 200,000 | 218,500 |
| *Tentative* Net Income | | $ 500,000 |

* The Pennsylvania Loans Tax and Bonus are not dependent upon net income.

## Step One: Computation of Tentative State and Federal Taxes

### (a) *Federal Income Tax:*

| | | |
|---|---|---|
| (1) Additional Data: | | |
| Fully or partially tax exempt interest income | | None |
| Net operating loss deduction................ | | None |
| (2) Computation of Tentative Federal Income Tax: | | |
| Tentative normal-tax and surtax net income | | $ 494,900 |
| Less: Net long-term capital gain........... | | 12,000 |
| | | $ 482,900 |
| 38% of $482,900 ................ | | $ 183,502 |
| 25% of $ 12,000 ............... | | 3,000 |
| *Tentative* Federal Income Tax...... | | $ 186,502 |

### (b) *Pennsylvania Income Tax:*

| | | |
|---|---|---|
| (1) Additional Data: | | |
| Pennsylvania income tax allocation percentage—51.33% | | |
| (2) *Tentative* Pennsylvania Income Tax.......... | | $ 10,217.49 |

### (c) *New York Franchise Tax:*

| | | |
|---|---|---|
| (1) Additional Data: | | |
| Interest on indebtedness to certain stockholders (item 34, page 1, Form 3CT)...... | | $ 3,500 |
| New York franchise tax for preceding year (item 39, page 1)........................ | | 14,500 |
| Business allocation percentage—43.24% | | |
| Investment allocation percentage—32.00% | | |
| (2) *Tentative* New York Franchise Tax, based on net income (*)........................ | | 9,416.90 |

### (d) *Pennsylvania Franchise Tax:*

| | | |
|---|---|---|
| (1) Additional Data: | | |
| Period during which taxpayer has been doing business in Pennsylvania during the taxable year 1947 (assuming taxpayer started operations in Pennsylvania on April 1, 1947)—9 months. | | |
| Pennsylvania Franchise Tax allocation percentage—70.33%. | | |
| Tentative value of capital stock (as appraised by the officers of the corporation): | | |
| (A) Value measured by the intrinsic value of net assets.................... | | $3,218,000 |
| (B) Value measured by net earnings.... | | 2,200,000 |
| (C) Value measured by average sales price of stock sold during the taxable year ..................... | | 3,282,000 |
| | | $8,700,000 |
| *Average* ........................ | | $2,900,000 |
| Values of (A) and (B) were arrived at as follows: | | |
| (A) Value measured by intrinsic value of net assets: | | |
| At beginning of 1947...................... | | $3,063,952 |
| At end of 1947: | | |
| Amount, before accrual for state and federal taxes ................................ | $3,558,550 | |
| Less: Tentative Federal Income Tax..... | 186,502 | 3,372,048 |
| Total .......................... | | $6,436,000 |
| Tentative value (Average)......... | | $3,218,000 |

(*) Should the New York Franchise Tax measured by capital or by net income plus compensation exceed such tax measured by net income, the formula supplied in Step Two, below, requires a slight modification.

| | | |
|---|---|---|
| (B) Value measured by net earnings: | | |
| Aggregate net earnings (after state and federal taxes) for the years 1943-1946........ | | $ 786,502 |
| Tentative net income, 1947................. | $ 500,000 | |
| Less: Tentative Federal Income Tax...... | 186,502 | 313,498 |
| Total of five years' net earnings..... | | $1,100,000 |
| Average net earnings: $1,100,000 x 1/5 (*)...................... | $ 220,000 | |
| Tentative Value $220,000 x 10 (†)...................... | | $2,200,000 |
| (2) Tentative Pennsylvania Franchise Tax: | | |
| Value of capital stock...................... | $2,900,000 | |
| 70.44% thereof............................ | $2,042,760 | |
| Taxable value for nine months (9/12 thereof) | $1,532,070 | |
| *Tentative* Pennsylvania Franchise Tax (5 mills thereof) ...................... | | $ 7,660.35 |

## Step Two: Computation of State Taxes

(a) *Formula for Computing Total of State Taxes:*

$$t = \frac{N}{D} = \frac{X+Y(f+1)+Z}{.04i+f+k(1-r)+1}$$

Explanation of Symbols Used Above:

| | | |
|---|---|---|
| t | (Unknown) = | Total of Pennsylvania Income Tax, New York Franchise Tax, and Pennsylvania Franchise Tax. |
| X | = | Tentative Pennsylvania Income Tax. |
| i | = | Pennsylvania Income Tax Allocation Percentage. |
| Y | = | Tentative New York Franchise Tax. |
| f | = | $\frac{.045b}{1-.045b}$, in which |
| b | | is the New York Allocation Percentage. |
| Z | = | Tentative Pennsylvania Franchise Tax. |
| k | = | $\left(\frac{m}{12}\right)\left(\frac{p}{200}\right)\left(\frac{1}{n}\right)\left(\frac{1}{2}+\frac{10}{w}\right)$, in which |
| m | | is the number of months in taxable year during which taxpayer has been doing business in Pennsylvania; |
| p | | is the Pennsylvania Franchise Tax Allocation Percentage; |
| n | | is 3 or 2, according to the number of values being averaged in computing value of capital stock; |
| 1/w | | is the weight given to net earnings of the taxable year in computing average net earnings; if simple average is used, w equals the number of years taken into account; |
| r | = | .38 or .53, according to the highest rate that was used in the computation of the Tentative Federal Income Tax. |

(b) *Computation of Total of State Taxes:*

Substituting in the foregoing formula the results of the computations, hereinabove performed in Step One, as well as certain of the additional data indicated therein, and solving for the unknown (t) will yield the total of the Pennsylvania Income and Franchise Taxes and the New York Franchise Tax, as $26,380.47.

(*) As a rule, equal weight is given to the net earnings of each year; the formula, Step Two (a) below, allows for instances where higher or lower weight is claimed for the net earnings of the taxable year.

(†) This has been capitalized at 10%.

(c) *Computation of the Amount of Each Tax:*

Once the total of all state taxes is known, the amount of each tax can be easily calculated by either of two methods:

*1st Method:*

| | |
|---|---|
| Federal net income is determined by deducting the total of state taxes in the amount of $26,380.47. The Federal Income Tax, so computed, amounts to.................... | $176,477.42 |
| Pennsylvania net income is determined by deducting the amount of $26,380.47. The Pennsylvania Income Tax, so computed, amounts to............. | $ 9,675.85 |
| Capital stock value, for purposes of Pennsylvania franchise tax, is determined by reducing both net assets and net earnings by state taxes ($26,380.47) and by federal income tax ($176,477.42). The Pennsylvania Franchise Tax, so computed, amounts to........... | 7,624.35 |
| New York franchise tax net income is determined by deducting Pennsylvania income tax ($9,675.85) and Pennsylvania franchise tax ($7,624.35). The New York Franchise Tax, so computed, amounts to.............. | 9,080.27 |
| Total of all State Taxes.......................... | $ 26,380.47 |

*2nd Method:*

As a check for correctness of calculations, the following work sheet may be used:

| | |
|---|---|
| Tentative Pennsylvania Income Tax = (X)............................ | $10,217.49 |
| Less: (t) (.04i) = (26,380.47) (.020532)............................ | 541.64 |
| Pennsylvania Income Tax.......................... | $ 9,675.85 |
| Tentative Pennsylvania Franchise Tax = (Z)............................ | $ 7,660.35 |
| Less: (t) (k) (1—r) = (26,380.47) (.00220125) (.62).................. | 36.00 |
| Pennsylvania Franchise Tax........................ | $ 7,624.35 |
| Tentative New York Franchise Tax = (Y) times (f + 1)............... | $ 9,603.77 |
| Less: (t) (f) = (26.380.47) (.019844127)........................... | 523.50 |
| New York Franchise Tax.......................... | $ 9,080.27 |

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It should be noted that a modification of the formula will necessarily be required in instances where contributions are not fully deductible because their aggregate amount exceeds the permissible allowance. In this case the revised formula for the computation would be:

$$t = \frac{N-(.05F-.95C)(D-1-k)}{D-.05(D-1-k)}\text{, in which}$$

F is the tentative federal normal-tax and surtax net income; and
C is the aggregate amount of contributions paid.

# New York State Tax Clinic

*Conducted by* BENJAMIN HARROW, C.P.A.

### Income Tax Regulations—Revised

The State Tax Commission has issued revised personal income tax regulations. A number of these are new, due to amendments in the law made by the 1947 legislature, and will now be referred to.

### Definition of Resident

Under Sec. 350(7), a taxable resident includes a person who, although not domiciled in New York, maintains a permanent place of abode within the state and spends in the aggregate more than seven months of the taxable year within the state. Sec. 350 7 (a) was added to the law by the legislature in 1942, providing that this definition of resident shall not apply to a person in the armed forces of the United States. The legislature in 1947 provided that this provision shall be in force and effect until July 1, 1948, or the termination of the present war as proclaimed by the President, whichever is earlier. The regulations (Art. 501) embody this legislative change. The law is effective for all taxable years commencing on or after January 1, 1941.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University. Mr. Harrow taught accounting at The College of the City of New York from 1919 to 1924. He has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is presently serving on the Society's Committees on Federal Taxation, State Taxation, Cooperation with the State Education Department and Its Agencies, and Cooperation with the Bar. Mr. Harrow is engaged in general practice as a certified public accountant in his own office in New York City.

### Aliens

Under the federal law nonresident aliens, even though in the United States, are not taxed on capital gains. During the past few years the Commissioner of Internal Revenue has put on a special drive in an attempt to bring such aliens under a taxable status. He has attempted either to consider them as being domiciled here if they have been in the United States for more than a year, or he has tried to construe their activities as coming within the concept of doing business here.

The State of New York has not had much difficulty in subjecting the nonresident alien to tax. In an opinion of the Attorney General issued in 1945, he stated that such an alien is a taxable resident if he spends more than seven months of the taxable year within New York. The opinion referred to aliens who have found refuge in New York from conditions existing in their native lands. Such aliens came to New York to reside and not for some temporary and special object.

### Domicile

This is one basis for jurisdiction to tax. The regulations (Art. 502) state that a New York domicile is not changed by removal for a definite period or for a particular purpose. Nor is the New York domicile changed merely by abandoning it. The acquisition of a new domicile must be effected legally through actual physical presence at the new domicile. The regulations state, however, that to constitute a change of

domicile there must be a new abode at the new domicile. A voting residence is usually evidence of a domicile and a person may have a domicile in New York even though he is still a citizen of a foreign country. The regulations state that a wife may acquire a separate domicile from her husband, although the general law is that a wife's domicile follows that of her husband.

The determination of domicile, says the regulation, is a question of fact rather than law. The Commission will thus spell out a domicile from a determination of the intent of the taxpayer and a statement of the circumstances affecting the issue.

**Permanent Place of Abode**

In the case of a person domiciled outside the state, such a home in New York is a basis for taxation in New York as a resident if coupled with the fact that the person spends an aggregate of more than seven months of the taxable year in New York. This would not apply however to a person who comes into the state to accomplish a particular object intending to remain only until he accomplished that object, even though he spent more than seven months of the year in New York. It would however apply to the alien who came here from a foreign land to seek a refuge. This provision was originally aimed at wealthy individuals who established a domicile outside of New York perhaps to escape the New York income tax, but who nevertheless live in New York with some degree of permanency.

**Property Subject to a Mortgage—Article 9 v. Article 9A**

Sidney Roberts sends us the following interesting comments on the valuation of real property under Article 9 and Article 9A.

Despite a close similarity in the applicable statutory language, different treatment is accorded, under Article 9 and 9-A, to real estate subject to a mortgage on which the taxpayer is not personally liable.

Article 9, Sec. 182(1), imposes a franchise tax on real estate corporations—"computed upon the basis of the full value of its gross assets***."

Article 9-A imposes a franchise tax on business corporations computed on several alternate bases. One of these imposes a tax on the taxpayer's "business and investment capital" (Sec. 210 (1) (a) (2)). Business capital is defined in part as follows (sec. 208(7)):

> "The term 'business capital' means all assets, other than subsidiary capital and investment capital, less liabilities***which are payable by their terms on demand or within one year from the date incurred***."

It is further elaborated (Sec. 210 (2)) as follows:

> "The amount of*** business capital shall ***be determined by taking the average fair market value of the gross assets included therein (less, in the case of business capital, average liabilities deductible therefrom which are payable by their terms on demand or within one year from the date incurred)***."

Where the taxpayer owns real estate with a long term mortgage on which the taxpayer is personally liable, the tax under Article 9 and Article 9-A is alike in including in the taxable base the entire value of the real estate, without diminution on account of the mortgage indebtedness. On the other hand, consider the case of real property merely subject to a long-term mortgage on which the taxpayer is not personally liable. The applicable words of the aforequoted provisions are as follows:

Article 9, Sec 182(1): "full value of its gross assets"

Article 9-A, Sec. 210(2): "average fair market value of gross assets" Sec. 208 (7): "all assets"

Article 9-A, Reg., Art. 332 provides:

"However, where the taxpayer owns property subject to a debt for which the taxpayer is not personally liable, only the taxpayer's equity in the property, over and above the amount of such debt, is included in business capital." See, also, 17 N.Y.C.P.A. 391, June, 1947)

On the other hand, under Article 9, the administrative practice is to impose the tax, not merely on the taxpayer's

equity in the property, but on the entire value of the real estate, without reduction of the mortgage.

The only discernable difference between the two statutes is, perhaps, the additional emphasis implicit in the word "full" found in Article 9. The word "full" first appeared in the statute as a result of Ch. 528, Laws of 1941, which amended Sec. 182, applicable to years beginning on or after January 1, 1942, to substitute the word "full" for "actual," as follows:

"the full (actual) value of its gross assets"

In a judicial proceeding, the amendment may possibly serve as a basis for the different treatment under Articles 9 and 9-A. On the other hand, an argument may be made against any such distinction on the theory that, where the taxpayer is not liable on the mortgage, merely the equity and not the entire real estate is the asset of the taxpayer. On this theory the issue must be resolved on the meaning of the term "gross assets," identical under both Article 9 and Article 9-A, and the question of value, whether "full value," "actual value," or "average fair market value," is not relevant to the issue.

This it appears to be a close matter of interpretation whether the word "full" in Article 9 is sufficient to sustain an interpretation different from that made under Article 9-A. However, unless a taxpayer is prepared to litigate, it is advisable to prepare returns under Article 9 without deducting the mortgage, whether or not the taxpayer is personally liable thereon.

**Deduction for the New York Franchise Tax**

The New York franchise tax is a deduction from gross income under the federal income tax law and a taxpayer on the accrual basis will of course accrue this deduction for the base and privilege year, even though the franchise tax is not due or payable until four months later. The taxpayer on a cash basis takes the deduction on the federal return in the year in which the tax is paid.

For state franchise tax purposes the deduction is a bit complicated and can be confusing. The law (Sec. 208(f)) provides that the deduction allowed shall be for the tax based on the period immediately preceding the period covered by the report. Specifically, the law provides that no deduction shall be allowed for any such tax based on the period covered by the report. For example, on the franchise tax return due in May, 1948, for the calendar year base and privilege period ending December 31, 1947, the accrued franchise tax for this period is not deductible for state franchise tax purposes. Instead the deduction allowed is the franchise tax that was due for the base and privilege period ending December 31, 1946. This provision applies both to cash and accrual basis taxpayers.

The regulations explain this provision (Art. 3(1)) by providing that federal net income must be adjusted by adding (A4) the New York franchise tax computed on the report being prepared, if deducted in computing federal net income; and deducting from federal net income (B 11) the New York franchise tax based on the period immediately preceding the period covered by the report, to the extent not deducted in computing federal net income.

Neither the law nor the regulations say in so many words that the above provisions apply to cash and accrual basis taxpayers alike. However the inference may be made that they apply to cash basis taxpayers by considering the definition of entire net income, which is total net income required to be reported to the United States Treasury Department, with the exceptions set forth in Art. 311. On the cash basis the taxpayer has deducted any franchise tax paid by him to arrive at net income. Such franchise tax is then added to federal net income under the provision in (A4). The taxpayer may then deduct the New York franchise

tax based on the period immediately preceding the period covered by the report. This editor can state that it was the intention of the Tax Commission to have the provision for the franchise tax deduction apply both to cash and accrual basis taxpayers.

One of our members poses the problem of when to take a deduction for an additional franchise tax paid, let us say, in 1948 and applying to the base and privilege year 1945. Under the provisions of the law and regulations discussed above, the additional franchise tax for the year 1945 is deductible in computing the franchise tax for the year 1946 either on the cash basis or accrual basis. Having paid the additional franchise tax in 1948, the taxpayer would file an application for a revision of the 1946 franchise tax and obtain a refund for the overpayment of the 1946 franchise tax. This may be an awkward procedure but the taxpayer has no other alternative. He certainly may not take a franchise tax deduction for the calendar year 1948 based upon the additional 1945 franchise tax paid, even though he is reporting on a cash basis.

### Computation of Franchise Tax Involving Two Related Unknown Factors

David Kessler, one of our upstate members, sends us the following computation of the franchise tax where there is a limitation of the deduction for contributions, which limitation depends also upon the franchise tax accrual:

If contributions of a New York corporation on the accrual basis exceed 5% of net profit, an interesting situation arises because of the two variables. The 5% contribution deduction allowable depends upon the franchise tax accrual, while the latter cannot be calculated without knowing the amount of the permissible contributions.

It is possible to reach a solution by trial and error, but the following formulae will readily give the exact deductions in the usual situation where the franchise tax for the current year is computed on the 4½% of income basis:

| | |
|---|---|
| Contributions ...... | 4.785768% of net profit plus 0.22551% of prior year's franchise tax. |
| Franchise Tax .... | 4.2846404% of net profit minus 4.510148% of prior year's franchise tax. |

It should be understood that the above formulae will not apply where a third variable such as employee's bonus based upon net income after all taxes is introduced.

EXAMPLE

| | | |
|---|---|---|
| Net Profit before contributions and franchise tax.............. | | $1,000,000.00 |
| Contributions .............................................. | | 100,000.00 |
| Prior year's franchise tax.................................. | | 90,000.00 |
| Contributions | | |
| 4.785768% of $1,000,000.00 equals........................ | | 47,857.68 |
| 0.22551 % of $ 90,000.00 equals........................ | + | 202.96 |
| Total .............................................. | (C) | $ 48,060.64 |
| Franchise Tax | | |
| 4.2846404% of $1,000,000.00 equals........................ | | $ 42,846.40 |
| 4.510148 % of $ 90,000.00 equals........................ | — | 4,059.13 |
| Balance ............................................ | (F) | $ 38,787.27 |

PROOF

| | | |
|---|---|---|
| Net Profit | | $1,000,000.00 |
| Contributions deductible | (C) | 48,060.64 |
| | | $ 951,939.36 |
| Prior year's franchise tax | | 90,000.00 |
| | | $ 861,939.36 |
| Current year's franchise tax—4½% of $861,939.36 | (F) | 38,787.27 |

* * *

| | | |
|---|---|---|
| Net Profit | | $1,000,000.00 |
| Current year's franchise tax | (F) | 38,787.27 |
| | | $ 961,212.73 |
| Less: Contributions—5% of $961,212.73 | (C) | 48,060.64 |

SOLUTION

The solutions for the two percentages follow:

P — profit before contributions and franchise tax.
C — contributions.
F — current year's franchise tax.
L — last year's franchise tax.

Equations:

1. $C = .05\ (P - F)$
2. $F = .045\ (P - C - L)$

Solving for C:

$$C = .04785768\ P + .0022551\ L$$

Solving for F:

$$F = .042846404\ P - .04510148\ L$$

* * *

The above computations have been based upon what is apparently the Department of Taxation and Finance's stand with respect to the limitation on charitable contributions, for presumably the income for the New York State Franchise Tax is the same as for the Federal Corporation Income Tax. It has been pointed out that, if the amount involved warranted it, a debatable case could be made that this is a special provision in the federal law that would not necessarily follow for franchise tax purposes.

It should be noted that this solution will apply only where the franchise tax is computed strictly on the basis of income and will not apply to any other basis. Also, as Kessler points out, that there may be some question as to whether the five per cent limitation applies for franchise tax purposes. Federal net income is only presumably net income for franchise tax purposes.

**Real Estate Corporation—Valuation of a Leasehold**

Last month we commented on this situation. Isidore Platkin sends us some interesting comments on the issue raised.

The New York State franchise tax on real estate corporations is partly based on the full value of gross assets

employed or situate in New York State on December 31 of the preceding year.

Where a corporation has title to the real estate it holds, the full value thereof is to be included among gross assets for tax purposes. The law prescribed no method for determining "full value". In practice we find that the Tax Commission will generally require that the tax be based on the higher of book value or assessed value, both of which are disclosed on the return.

A corporation wholly engaged in subleasing of real property held under a leasehold of twenty years or more, by the terms of which it pays the real estate taxes on the property, is also taxed as a real estate corporation. Here a question arises not only as to how the asset is to be valued but also as to what constitutes the asset.

The leased property certainly is "employed" in the lessee corporation's business of subleasing. Should the full value of the property be included among the assets to be taxed? It may be argued, in support of the negative, that the property is not "owned" by the lessee and would not ordinarily appear as an asset on the lessee's balance sheet. Yet when a real estate corporation takes title to property subject to a mortgage, it is taxed on the value of the property without deduction for the mortgage, although it may well argue that its asset is only the equity above the mortgage.

A better argument against including the value of the property in a lessee corporation's tax basis is that such procedure would involve double taxation of the same property if the owner were also a real estate corporation.

But suppose the lessee has "improved" the property. Such improvements would become the property of the lessor, yet the lessee would generally include "Leasehold Improvements" among its assets for balance sheet purposes. Should the improvements be included among its assets for franchise tax purposes? If we conclude that the property itself is not taxable to the lessee, it seems to follow that improvements to the property likewise should not be taxed to the lessee. In fact, to the extent that the value of the property has been increased, improvements by the lessee should increase the tax basis of the lessor.

It may seem reasonable that the value of the leasehold, rather than the value of the property should be taxed to the lessee. If so, one of the criteria of value used by the Tax Commission where title is held, namely assessed value, invariably would be lacking. If the lessee had purchased the lease, the unamortized cost generally would appear on the books and might serve as a basis for tax. But if the lease were obtained directly from the owner, without payment of a premium, there would be neither cost, nor book value involved. In such a case, could the Tax Commission attempt to place a value on the leasehold?

# Accounting at the S. E. C.

*Conducted by* William W. Werntz

## Revised Proxy Rules

On December 18th revised proxy rules under the Securities Exchange Act became effective with respect to any solicitation commenced on or after February 15th. In the meantime, either the old or the new rules may be followed. Drafts of the rules were circulated for comment last fall. While so many changes have been made from the old rules that it is not feasible to summarize them here, two or three changes from the draft proposal may be mentioned. In the final rules the requirement to state "the per-share cost to common stockholders" of bonus and pension plans, which was criticized in the *December* issue, has been deleted; also, the rules retain the pre-existing definition of associate and restrict individual remuneration data to directors, including nominees, and the *three* (instead of five) highest-paid officers receiving over $20,000 exclusive of pension and retirement plan costs.


William W. Werntz, formerly Chief Accountant of the S.E.C., is now associated with Touche, Niven, Bailey & Smart, C.P.A's.

Mr. Werntz is a graduate of Yale University and of Yale Law School, and is a member of the Connecticut Bar. He was formerly an instructor of accounting at Yale University and Yale Law School. He was also an accounting consultant to the O.P.A. and the Treasury Department.

Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications. He is Vice-President of the American Accounting Association.


## Mr. Caffrey's Address

Chairman Caffrey addressed the last annual meeting of the American Institute of Accountants on the subject of "Plain Talk in Accounting." His remarks indicated an understanding of the accountant's task and problems that will be gratifying to all practicing accountants. The address avoids any technical discussion of accounting problems of the day and instead seeks to outline some problems of the layman who must, Mr. Caffrey says, rely upon accounting data presented by the company and, generally, reported upon by an independent public accountant. His approach to the income statement is well worth consideration:

> "An accountant necessarily deals with terms of art. But those terms have popular meanings to the non-professionals who read and rely on accountants' statements. While I might be ill at ease in technical arguments about the full implications of such words as 'profit,' 'income,' 'surplus' and 'depreciation,' when I read an accountant's statement I have a very well-defined reaction to these words. I assume that their character and quality of these accounts are the same for different statements of the same or different businesses. I assume that the accountant has told me how much the business made or lost during the year and how much it can pay out without impairing the investment. I expect the statement to be complete: if it covers income and outgo I feel entitled to believe that charges and credits have not been tucked away or placed anywhere else. If there are necessary qualifications to what I read in the figures I assume that these will be flagged for me where they are most pertinent and will be stated in such a way as to permit me to appraise the statement intelligently.
>
> "These are the things a layman expects. In my opinion these expectations are the core of accounting. They are the common ground upon which the public and the profession communicate; they are the only source of vitality for accounting concepts; they define ideals—vague and difficult as they may be—toward which the philosophy

and language of accounting must move to be vigorous and meaningful. When accounting terminology loses touch with common meanings it becomes at best a verbal exercise and at worst a polite method of lying. As necessary as it may be for the accountant to choose between alternative theories or alternative applications of theory in the course of making his statement; as multiple and as complex as may be the elements that go into the achievement of the net result, it must mean pretty much what the layman thinks it means or it has no public meaning at all.

"Thus, there are necessary limitations to the art of accounting. It cannot be permitted to take the accountant so far afield that his language loses its essential touch with reality. The common man's understandings of accountants' words are heavy anchors against drift in representation of of financial facts. They must form, in all statements, for all companies, and wherever used, the essential content of accounting terminology.

"Every generation brings with it those who strive for certainty, and it brings also those who insist that certainty is a will-o'the-wisp. Of course, absolute certainty in accounting is not now, and may never be, an achieved fact. But it is nonsenical and dangerous to deny its validity as an ideal. Your profession has in the past decade made many improvements in that direction. They are palpable evidence that we can go still further.

"There is a vast premium in continuing efforts to achieve certainty, comparability, and rigid independence in accounting. We must remember that an accountant's presentation is, to most people who read it, like a mariner's compass in the fog. It is all they have to go by. If the guide fails they are lost. They cannot trace back the method of arriving at the statement. They do not have the skill to temper their reading with sophisticated judgments about diversities in accounting treatments. They have no choice but to assume that the accountant's presentation means what it says and that it tells the whole truth, on the basis of an independent and thorough survey of the facts.

"Full respect for the stewardship inherherent in the position of the accountant requires more than conscientious performance by individual practitioners. Who is to blame if the balance sheets and income statements of the X and Y companies certified by different firms, are found to use the same language, within the scope of accepted or acceptable accounting principles, to describe different things? There may be excellent arguments to justify both presentations and both may have been conscientiously certified. However, if they use the same words to describe different things even an experienced investor who makes a comparison between them has been seriously misled by a dangerous though honest falsehood. Each statement, telling the truth in its own way, is justifiable. Put together they distort each other."

In closing, Mr. Caffrey paid full tribute to the cooperation accorded the Commission by the Institute and stressed a fact which is often lost sight of—that progress in accounting has and should come by voluntary adoption and observance of professional standards far more than by coercion.

## More Income vs. Surplus

In an address before the New Jersey Society of C.P.A's. on December 16, 1947, Earle C. King, Chief Accountant of the S.E.C., restated the views of the Commission's staff on the surplus income controversy (reported in the *January* issue), but in this more definite language.

"It has been our position, which we have expressed repeatedly and maintained consistently, that ordinarily all items of income and expense recognized during an accounting period should be included in the determination of net income for that period; that any extraneous items, material in amount, should be clearly explained; that such items might properly be shown in a separate and final section of the income statement but before the determination of net income; and that the final caption of the income statement should be 'Net Income'."

More important, he quoted the text of a letter authorized by the Commission to be sent to the American Institute of Accountants in connection with the latter's Accounting Research Bulletin No. 32. The divergence in viewpoint is clear from the following excerpt:

"The issuance of Accounting Research Bulletin No. 32 entitled 'Income and Earned Surplus' by the Accounting Procedure Committee of the American Institute of Accountants raises several important problems of vital concern to this Commission, as I have indicated to you by letter and in conference from time to time in the course of the development of the bulletin. The procedures recommended in the bulletin seem to be susceptible to abuse and may result in misleading income and earned surplus statements in conflict with published rules and opinions of

the Commission as well as of opinions of the Chief Accountant, inasmuch as they:

(1) make mandatory the exclusion of certain specified items from the determination of net income 'when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom';

(2) permit the items so excluded to be shown either at the bottom of the income statement immediately following the 'amount of net income' or as direct charges or credits to surplus;

(3) permit the commingling of the items excluded from the determination of net income with appropriations to general contingency and inventory reserves made from net income, and

(4) prescribe no caption for the final item on the income statement when any of the items referred to in (2) or (3) are shown therein.

"Under these circumstances the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32."

### Thomascolor Incorporated

The latest in a long line of opinions dealing with promotional companies that register to sell securities under the 1933 Act is in the matter of *Thomascolor Incorporated* (Securities Act Release No. 3267, November 26, 1947). In the instant case, amendments were filed of such nature as to cause the Commission to dismiss the proceedings and permit the statement to become effective. However, since the Commission seized the occasion to issue a rather detailed opinion, it will be discussed next month.

### Premiums on Preferred Stock

Regulatory commissions encounter accounting principles in some unexpected situations. For more than four years, it has been Commission policy (Accounting Series Release No. 45, June, 1943) to require that premiums paid on retirement of preferred stock be charged to any existing earned surplus to the extent the premiums paid exceeded premiums received thereon. This position accords with that of the American Accounting Association, but has been viewed with disfavor by many, though by no means all, public accountants. Release 45 itself indicated the possibility of divergence between accounting principles and regulatory objectives through special reference to certain utility cases. On the other hand, no instance is known in which the fiction of a premium paid and received has been invoked to require a charge to earned surplus in the case of a share for share exchange offer, with no boot.

Such exchange offers have been fairly frequent as a means of reducing high dividend rates often found on old stock. The instant case (*Louisiana Power & Light Company,* Holding Company Act, Release No. 7906, December 15, 1947) is typical. The Company had outstanding some 59,000 shares of $6 preferred stock having a stated value of $100 per share. A new preferred stock of $100 par value was to be offered in exchange for the old on a share for share basis. Both the old and new stock had a voluntary and involuntary liquidation preference of $100 per share plus accrued dividends and a redemption price of $110 per share. The new stock was to bear such dividend rate as "would produce a market price of at least $110." Unexchanged shares would be redeemed at $110, with money therefor provided, if necessary, by sale of common stock to the parent.

In previous cases (*Union Electric Company,* Holding Company Act Releases Nos. 6594 and 6910, 1946) the Commission had stated that, as a matter of policy, the maximum premium on new preferred issues would be limited to 2¾ points, for reasons set out below. If that policy had been adhered to in this case, exchanges would probably have been few, since by requesting redemption present shareholders would get $110 per share rather than a security with at most a $102.75 market value per share. Moreover, on that basis, redemption of the old shares would have necessitated, under the Commission's announced accounting views, a

possible charge to earned surplus of $10 per share or $590,000. On the other hand, both the staff of the Commission's Public Utility Division and the registrant appear to have taken the position that as a matter of accepted accounting practice, no premium, paid or received, need be recorded in a share-for-share exchange offer of shares having the same par or stated value.* Accordingly, if the dividend rate were set to bring $110 per share in the market, redemption and exchange would, presumably, be equally attractive on a purely price basis and to the extent shares were exchanged, there would be no need for a charge to earned surplus and an offsetting credit to capital surplus to record a $10 premium "paid" on the old stock and "received" on the new. Thus, the actual issue was whether, in view of its previously announced policy, the Commission would permit issuance of preferred stock with a dividend calculated to yield a market price of $110. The Commission, voting 4 to 1, determined to permit the issue, but stated specifically that the case was decided on its special facts as an exception to the general policy. The following excerpts from the opinion are of considerable interest as a reflection of the interplay of accounting and regulatory considerations:

"Unless applicant is permitted to issue the New Preferred at the proposed premium it will be compelled (unless the plan is altered to require the issuance of more preferred shares) to make a cash outlay for the amount of the redemption premium and record a charge to surplus. On the other hand, according to generally accepted accounting practice which in an exchange transaction of the type proposed here recognizes no payment of a redemption premium or receipt of an issue premium, the proposed plan will avoid the necessity of making a charge to surplus at this time, although such a charge will eventually be made should the New Preferred ever be redeemed.

"The staff, while not directly challenging the validity of the accounting practice, contends that in effect Louisiana is redeeming its outstanding securities at $110 and is issuing a new security with a value of $110, so that it is in fact paying a $10 premium on account of the old and receiving a $10 premium on account of the new shares. This, says the staff, would not be reflected on Louisiana's books pursuant to the accounting practice and, therefore, certain adverse consequences would follow. These consequences can be avoided, according to the staff, only by preventing Louisiana from promulgating an exchange in which the practice would apply.

"Before considering the contentions of the staff, we note that the validity of the accounting practice which is said to make these adverse results possible has not been put in issue. Both the staff and the applicants have assumed the validity of this practice and for purposes of this opinion we think we may proceed on the same assumption in determining the issues before us. We need decide only whether the possibility of harm in the circumstances of this case is so great as to outweigh the benefits and savings of the exchange proposed by the management.

"The staff claims that the proposed exchange will conceal the true cost of preferred stock money. It claims also that by the simple expedient of adjusting the dividend rate Louisiana will have altered its true capital ratios so as to improve the apparent common stock equity at the expense of the preferred, thereby making it possible to pay dividends in excess of surplus (adjusted to reflect the payment of a premium), and possibly affecting adversely legal and regulatory safeguards which are based in part on capital ratios.

"Primarily, it should be noted that the 'concealment' referred to by the staff occurs in any case of sale of a note or preferred stock at any premium or discount. Thus, even under the policy of permitting limited premiums there is concealment of the 'true' cost of money. In principle, the 'concealment' in this case is no more invidious, although the degree is greater, than in any case of sale at other than par or principal amount. From the regulatory point of view adverse consequences follow only if the regulatory body, desiring the facts, cannot obtain them. In this proceeding, and otherwise, the full facts surrounding the nature of the exchange are revealed.

"Similar considerations apply to the staff's contentions with respect to capital ratios and the ability to pay dividends. Neither we nor any other commission with jurisdiction over dividend payments will be debarred from considering, whenever it becomes relevant, the effect of this exchange on the propriety of a proposed divi-

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* Citing a bulletin to that effect issued by the Committee on Statistics and Accounts of the National Association of Railroad and Utilities Commissioners (Case E-79).

dend. It should be noted that, in raising the issue of the propriety of future dividends based on the unchanged surplus, the staff is indirectly attacking the accounting practice it concedes. Were we to give dispositive weight to this contention we would necessarily be deciding that the accepted accounting practice is erroneous, but, as we have indicated, we do not have that issue before us and do not have to decide it here. Moreover, we may note in this connection that, as a result of the proproposed refinancing, the financial condition of the company will be improved by reason of the reduction in present dividend requirements, and, to the extent that unexchanged prefrered stock is redeemed, by an increase in the proportion of common stock equity in the capital structure.

"The staff points out that redemption prices tend to set approximate ceilings on market prices. Thus a preferred stockholder making the exchange will receive a stock selling at or close to the top of its market potential. It is pointed out, further, that the new stock (like the old) has a liquidation value of $100 and, it is stated, should the company liquidate, the new stockholder would receive substantially less than the initial market price which formed the basis of his exchange.

"These arguments would have more weight as applied to a forced exchange than they do here where the exchange is voluntary and preferred stockholders are being provided with an opportunity to receive their maximum claim in cash. The only contingency which would result in patent unfairness would be an imminent liquidation which would deprive the holder of New Preferred of an opportunity to continue with his investment while paying him only $100. However, should Louisiana's liquidation take place under our jurisdiction we would be able to make appropriate safeguarding provisions. Moreover, while we believe these considerations urged by the staff do not warrant denial of this application relating to a voluntary exchange, we think that preferred stockholders should bear these factors in mind in considering exchanges. We will scrutinize any proposed solicitation literature to see that it contains an appropriate description of these matters.

"The policy of limiting maximum premiums to 2.75% achieves certain desirable results. First, if a new security is given a par of $100 or some multiple or simple quotient thereof, limiting the premium makes it fairly easy to compare the yield with current market yields. While ease of comparison is desirable we do not think that sufficient additional difficulty in comparing relative yields on Louisiana's proposed preferred stock and on other securities is created by the premium proposed here to justify our rejection of the proposal. More important than ease of comparison are other considerations urged upon us in this case. Some of them we have already discussed. In addition the staff has stated, and has introduced charts to demonstrate, that the cost of money tends to increase out of proportion with increase in issue price as the issue price exceeds par. Studies made by the staff indicate that an issuer must pay higher dividends or interest to sell a high premium security than it would have, proportionally, to sell a security priced closer to par. Whatever the reasons for this may be, it appears that the market must be stimulated to take high premium securities by offers of better yields than are available at lower prices.

"We have considered the probable effect on the cost of money of the proposed exchange, with a dividend rate geared to yield a market of $110 (as distinguished from the limit of 102.75 proposed by the staff). We have concluded with regard to the special facts of this case, that the difference would be so slight in this case as not to warrant a denial of the application."

To be sure, the significance of the case, in accounting, would have been greater had the accounting principles been put in issue, rather than conceded. But it is nevertheless important since in it regulatory considerations are discussed only after assuming the generally accepted accounting practice applicable in the circumstances, and there is no discernible tendency to solve the case by disregarding the accounting principles stated to be applicable to the situation.

In the circumstances, to discuss the merits of the accounting point might appear to approach impertinence. Still, one or two observatios may be in order. The principal issue is whether, as a matter of accounting, shares of stock issued in a share for share exchange for outstanding shares of equal, fully paid par or stated value must for record purpose be assigned a "fair market value" as is done where shares are issued for property; or whether such transactions fall generally within the area of merger and intracompany readjustment in which the stock issued in exchange for old stock is not ordinarily recorded on the basis of market values, but instead is recorded on the basis of pre-existing

capital contributions. Also, granting the propriety of charging redemption premiums to earned surplus (which some—perhaps many—would not), is that policy of such virility as to make mandatory the transfer of earned surplus to capital surplus in an amount equal to the voluntary redemption premium although no new dollars are paid in and the identical persons remain as stockholders? To us, it seems the answer ought to be "no premium" on either line of inquiry—at least in cases presenting no unusual circumstances and where no attempt is being made to compensate the old shareholders for an unsatisfied right such as accrued unpaid dividends.

## AN ADIRONDACK VIEW

The northern lights may have seen queer sights; perhaps the queerest was when dear old dead Sam McGee sat up in the firebox of the "Alice May"; but have you ever considered the queerness of good old Form 1040 plus the instructions and regulations with which he is clothed?

Without getting technical and messing around with illustrating examples, here is what is supposed to be done with income to fix up old Form 1040:

1. Some income you just forget about.
2. Some you put in at 3% of what you paid for what you bought to produce the money you got.
3. Some you chop in two, exactly.
4. Some you put in at one place and leave out in another; but, on some of this, after you have left it out in one place, and before you put it in the other, you take out all that was earned from loaning a certain amount, or less, to a certain party, before March came around in 1941, but after September hit in 1917.
5. Some you put in when you earn it whether you get it or not; and some you put in only when you get it regardless of when you earned it, or whether you earned it or not.

And as for the things that get pulled out in dear and queer Form 1040, take a sober look at these, and you won't need a highball later—or perhaps you will:

1. Deduct the cost of getting around to earn your pay if your boss gives you the dough for it; if he doesn't you can't deduct it, that is not on page 1; that page is a very special page and has to be treated with top level amenities, like the janitor now-a-days. But page 3 is different, you can deduct it there; however, before the pilgrim's progress arrives at page 3 he will be sick of the whole thing anyway, will tear on the dotted line (a modern habit), and throw that page and the taxes that are on the back into the ash can; wishing, of course, that the tax to pay was *with* the table, instead of *per* the table.
2. And those loans that never came back—if made to an enemy, take them out; but if you helped your brother out of a hole—no, no, no, forget them, charity my friend, just a little family affair. A prudent business man should know better than to loan money to his brother, or father, or son.
3. Deduct the loss on the motorboat you sold or your automobile or your house? Not by a jug-full! But sell them at a profit and see what happens, this is a cat with a different ancestry; go get Schedule D, your slide rule, magnifying glass, and call for competent counsel—the furnace man at your brokers, for example.
4. And don't give away too much, if you do the 15% limit will teach you to control your charitable instincts. Form 1040 does not allow wild giving.
5. But when you get sick don't be bashful, step on the gas and let 'er roll. Unless you do a good job of it you can't deduct anything. But don't overdo and be too sick—you might not be able to deduct it all or you might croak, and croaking expenses are not among the deducts. A man must exercise control in all things, even medical expenses—too little is not enough and too much is in excess of being extraordinary.

* * *

Well, it's a queer world. Some folks would like to see Form 1040 and Sam McGee swap places.

By Leonard Houghton, C. P. A.
*President et al., Adirondack "Chapter"*

# The Taxpert

*By* Lewis Gluick, C.P.A.

### Community Property

We read Godfrey Nelson's article in The New York Times of December 14th and enjoyed his comments on the *Wilcox* case, which puts Pennsylvania out of the community property list. Then, we turned to the first section and on page one found the announcement that, unless Congress granted universal division of income, Governor Dewey would be obliged to recommend that New York adopt a community property law. He estimated that New York citizens were losing upwards of $170,000,000. per year as compared to the old Spanish law states. What political significance that has, if any, we don't know. Perhaps by the time this gets in print, Congress will have enacted the law. But you can take it from us, California isn't going to like it. Many people claim that it is unfair, even unconstitutional, to accomplish tax reduction for only 35 or 36 states. And you can't convince them that it was equally unfair for twenty years for the community property states to get the reduction they enjoyed. "That's different!" is their comment. And don't fool yourself that the old community bloc is going to take it without a struggle, albeit one behind the scenes. And with an election coming up, and California having a lot of votes, anything may happen. Taxwise or otherwise, *verbum sap.!*

Lewis Gluick, C.P.A., has been a member of our Society since 1924. He is now engaged in practice in Long Beach California. He is best known as the Shoptalker, under which name he has been writing since 1928.

### Old Stuff

The following is taken from the December, 1932, issue of the "Certified Public Accountant", the magazine of the old American Society of C.P.A.'s. It should be read in connection with Internal Revenue Code, Section 2401.

> "Of all the nuisance taxes imposed last session of Congress, the one which has hit New York hardest is that on fur garments. We agree that the tax is iniquitous. We predict that revenue men will be contesting appeals long after Roosevelt is finished with his first term (323 CCH #6416)."

A truer prediction never appeared in the Shop. Furthermore, if you will just substitute the name of the man you think will be elected in November, 1948, you can consider the prediction renewed.

### Saving?

We quote from page 801 of our December issue.

> "An inactive corporation not formally dissolved, is now not required to file an income tax return. The corporation must show that it has ceased its business, has retained no assets and has no income."

Heck, Mr. Harrow! In order to comply with IT 3871 and satisfy the Collector that you don't have to file a return, you could probably file an 1120 and save time.

### Poor Papa!

A stand out for human interest is the case reported at 9 TC, No. 65. Technically it is trite. The Commissioner was sustained. But the human interest is what appeals to us. A father, striving earnestly to keep his son in business, endorsed the boy's notes. The son went bankrupt anyhow, and the Court ruled that the father had made a gift;

not sustained a deductible bad debt loss. Poor Mr. Ellisberg!

### Cases

Samuel Goldwyn is more or less of a Hollywood legend. True or fictitious, his attacks on the English language, are an accepted part of a tradition. There is nothing fictitious in his case, 9 TC, No. 71. A five man dissent means a certain appeal, and we hope Goldwyn wins.

The court was evidently in a bad humor that day, for 9 TC, No. 73 & 74 also have five member dissents.

We really like the decision in the *Schairer* case, 9 TC, No. 75. A corporation reimbursed its Vice-President for the loss he incurred on the sale of his residence, necessitated by his removal, on corporate business, to another city. The Commissioner tried to tax that reimbursement as additional compensation. The Court, *without dissent*, found for the taxpayer. That's justice!

Another pleasant case is that of *Stifel*, 9 TC, No. 79. A family partnership was held to be bona fide.

Divorce lawyers should note the *Dauwalter* case, 9 TC, No. 80.

Taxperts in Oregon are going to need extra scratch pads and pencils this season. In fact, were we a calculator manufacturer, we'd put extra salesmen into that territory. The effective date of the Community property act is July 5 (IT 3868).

### Laugh of the Year

Arthur Metzger tells this one. He says he was an eye and ear witness.

A young deputy-collector was arguing with a taxpayer. The latter, irate, pounded the counter and said "Well, if using my auto to collect rents isn't a necessary *business* expense, what is it?" To which the young deputy replied "Believe me, mister, in my case it would be a pleasure!"

### Correction

On page 849 of the December, 1947, issue a typographical error caused a mistake to appear in the reference to David Dodge's (C.P.A.) new book "How Green Was My Father."

# CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

Over the past few years I have voiced dissatisfaction with the standard short form of accountant's report. In September, 1941, it was pointed out, as to the first sentence thereof, that it was improperly punctuated; but apart from that feature, the joining, as equal ranking clauses with the statement "we have examined," of various steps taken in the examination, impairs the intent of the word "examined." The thought relationship does not warrant the clauses following the first one being included in parallel positions with it as though of equal importance.

It is interesting to note in the appended short report form adopted by one of the largest firms, that this situation has been recognized. The report referred to with names deleted, is as follows:

To the Board of Directors of
the "Anonymous" Association, Inc.:

We have made an examination of the balance sheet of "Anonymous" Association, Inc. (a membership corporation, organized under the laws of the State of New York) as of May 31, 1947, and of the related statement of income for the fiscal year ending May 31, 1947. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included such tests of the accounting records and other supporting evidence, and such other procedures as we considered necessary.

In our opinion, the accompanying balance sheet and related statement of income present fairly the financial position of the "Anonymous" Association, Inc. as of May 31, 1947, and the results of its operations for the year ending May 31, 1947, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding fiscal year.

It might be said that the comma after the word "evidence," should be omitted but that is a small matter. A criticism could be made of the continued use of the phrase "present fairly the financial position." According to Fowler's Dictionary of Modern English Usage (section designated as position of adverbs) it is improper to place an adverb between a transitive verb and its object; it belongs either before the verb or after the object. Perhaps the intent of the composers of the standard form was to get the word "fairly" next to the object to indicate a close connection with "the financial position," but, of course, an adverb cannot qualify a noun.

Someone afraid of his grammar, as an English professor phrased it, might offer a criticism of the use of the word "ending" in "fiscal year ending May 31, 1947." Idiom is preferable to merely correct grammar. The phrase is idiomatic; it is also the historical present. A fiscal year which began June 1, 1946, will always end on May 31, 1947. I have no quarrel with those who prefer to say "year which ended," but "year ended" is less agreeable.

Very truly yours,

A. S. Fedde

New York, N. Y.
December 18, 1947.

# BOOK REVIEWS

## Investigations for Financing

By David Himmelblau, Assisted by the Staff of the Department of Accounting of Northwestern University. THE RONALD PRESS COMPANY, New York, 1947. Pages 371, $6.00.

This volume is limited to accounting investigations in connection with proposed long-term financing through the sale of securities to the public or large institutional investors. It concerns itself exclusively with those auditing procedures which are applicable under the circumstances, and the special reports to be prepared for the use of bankers contemplating a proposed issue of securities or for inclusion, by issuers and bankers respectively, in registration statements and prospectuses required to be filed with the S.E.C.

The general plan of presentation follows the "Unit Lecture Method." The text consists of fifteen chapters, each of which, together with its related problems, questions and correlated audit work papers, represents a separate unit of instructions. Lecture 1 covers the preliminary analysis of the company figures to determine the subject matter to be investigated. Lecture 2 deals with the drafting of adjusting journal entries, particularly where several years are involved. Lectures 3 to 7 inclusive outline the procedures to be followed in auditing the various balance sheet and related income items. Particular emphasis is placed on the differences between the verification procedures in an annual audit, and those in special investigations for long term financing, mergers, consolidation and reorganization. Special consideration is given to verification and valuation of inventories (Lectures 4 and 5) and property accounts (Lectures 6 and 7) both of which recently have been the subject of much controversial discussion between management and independent public accountants.

The purpose of the investigation will determine the type of report to be prepared. Lecture 8 is devoted to a detailed discussion and illustration of "Statements of Application of Funds" as a means of analyzing the character of financial changes during period under review. Lecture 9 concerns itself with a brief outline of the financial statements required to be filed for industrial corporations registering an issue of securities with the SEC. The financial statements taken from the registration statement of the American Potash & Chemical Corporation are included for illustrative purposes. The student and practitioner will find this chapter particularly helpful as a guide to basic SEC sources and other authoritative writings in the field. The pro forma balance sheet is covered in Lecture 10.

Where an issue of securities is proposed for sale to the public, the most important phase of the auditors investigation centers upon the prospective ability of the issuer to meet fixed charges for interest, dividends, and/or sinking fund during the term of the securities. To this end a proper determination of past earnings as a basis for future estimates is a focal point of the investigation. Lecture 11, entitled "Corporate Earnings" covers this very important topic extremely well. Lectures 12 and 13, respectively, discuss in some detail the auditor's certificate and the practical problems to be considered in writing the report. The final lecture goes into a rather comprehensive discussion of Industrial Analysis.

This is a specialized work, designed as a text for advanced students and independent public accountants, who are especially interested in the auditing procedures applicable in accounting inves-

tigations for long-term financing, mergers, consolidations and reorganization. It assumes, as a prerequisite, the completion of an auditing course covering annual audits for shareholders and the auditing workpapers applicable thereto. The book is well organized, contains many practical illustrations selected from current published corporate reports and is amply supplied with problems and questions suitable for both class discussion and home assignments.

University instructors will find this a most excellent text for their students, and independent accountants a valuable addition to their library.

B. Bernard Greidinger

Graduate School of
Business Administration
New York University

**The Fund Theory of Accounting and Its Implications for Financial Reports,**

By William J. Vatter, University of Chicago Press, Chicago, Illinois. A Supplement to the Journal of Business of the University of Chicago, 1947. 123 pages, $1.50.

What the author in his Preface calls a "little excursion into some untried and rather speculative areas of accounting thought" turns out to be a very argumentative and very closely reasoned exposition of his analysis of, and expansion upon, the fund theory of accounting.

The author is of the opinion that "neither the proprietary theory nor the entity theory is a wholly satisfying frame of reference for accounting. Each is vulnerable in that it adopts a personality as its focus of attention—The weakness in these personalized bases for accounting is that the content of accounting reports will tend to be affected by personal analogies; and issues will be decided not by considering the nature of the problem but upon some extension of personality—to reach or to support conclusions that are for the most part mere expediencies." Prof. Vatter feels that in view of the many parties, governmental units, stockholders, bondholders, short term credit grantors, management, employees, etc., who are interested in the financial records of an enterprise, it would be well if an "area of attention—a delimited and prescribed set of activities" should be the unit of business or the "fund" for which the accountant ought to prepare a report. "In this sense of 'fund' there are involved (1) a segregation of assets for a given purpose and (2) a partial recognition of the set of separate operations which pertain to these assets."

In the course of his monograph, the author finds it necessary to define his terms or rather to redefine accounting terms. His primary definitions are that assets are "service potentials", that wealth is "an aggregation of service potentials" and that equities (liabilities and proprietorship claims) are "restrictions that apply to assets in the fund and which therefore condition the operations of the fund as dictated by management." The balance sheet equation therefore is: assets equals restrictions upon assets. Revenue (gross income) results from asset increasing transactions in which "the new assets are completely free of equity restrictions other than the residual equity of the fund itself" and expenses become "simply the draining off or the release of converted services into certain channels during some period of time."

He summarizes his theory as follows:

"1. The fund, not some person connected with it, is viewed as an entity.

"2. Valuation, so far as fund accounting is concerned, is a minor issue; . . .

"3. Equities, or whatever the right-hand balance sheet items are called, are viewed as restrictions upon assets, not as legal liabilities; . . .

"4. The segregation of long-term from short-term items is maintained in somewhat more definite ways when fund accounting is employed. . . .

"6. One of the distinctive features of fund accountings is the absence of emphasis upon 'net income' and related notions of 'profit,' 'operating margins,' and the like."

Funds may take many shapes. The division of the various operations of an organization may be made on any useful basis. A very interesting division into "capital fund" and "current fund" is part of the author's discussion. However, when he finally gets down to his summarizing illustrative chapter he divides his organization and its operations into the following funds: (1) Cash and Banks Fund, (2) General Operating Fund, (3) Investment Fund, (4) Sinking Fund-Current, (5) Sinking Fund-Investments and (6) Capital Fund. He suggests that some of these might very well be subdivided or have sub-funds included in therein. Statements of the various funds are not consolidated, but merely presented in parallel columns.

It is the author's theory that giving the statements of funds rather than one balance sheet and one profit and loss statement, puts the reader in a position where he not only has all the information which is necessary for him to determine the facts which he requires for his particular purposes, but also puts him in a position where he *must* make the analysis and compilation himself since the report itself does not submit figures of such a nature that "the reader can seize upon some one figure (usually an inadequate one) to serve his purpose."

The monograph is a very interesting one. It covers a field in which there has not been too much discussion, and should certainly start a considerable flow of literature regarding fund accounting. At the very least, the many persons who are quoted in order to be refuted should be ready with their side of the picture in the near future.

The article loses out, however, by its argumentativeness. Had less time been spent on breaking down the position of other writers and had the pamphlet consisted of a straight exposition of the point of view of the author and a straight analysis of the fund theory as he envisions it, the reader would be left with a clearer notion of what the author is driving at. His analysis of other and opposing theories and his arguments for, rather than explanations of, his theory might very well have been removed from the body of the article and put into a supplemental pamphlet or in an appendix.

I trust that the near future will see an article by Professor Vatter which will give his analysis of the fund theory without requiring the reader to wade through his arguments with all the writers in accounting he could find to dispute.

RALPH G. LEDLEY

New York, N. Y.

**Business Law Questions,** with annotated answers. (Suggested answers to questions asked on Wisconsin C. P. A. examinations, 1937-1946.) By H. M. Schuck. THE UNIVERSITY OF WISCONSIN, Madison, Wisconsin, 1947. 81 pages, $1.10.

The title of this pamphlet suggests that it was prepared primarily as a review of legal principles for CPA candidates. The author states in his preface, however, that the work "is designed primarily as a review of business law for accountants" and that its publication is based in part on the belief that the contents will be of interest and value to businessmen generally. In a word, it was not intended to serve as a substitute for a textbook on commercial law. If it were, like all such textbooks, it would at best be of doubtful value. If a businessman or an accountant wants a legal background he had best get a casebook and study it under a competent instructor. Statements of legal principles or questions and answers will give him no perspective of the law in operation.

The Wisconsin C.P.A. candidate will find the work of particular value. Some eight topics are listed and questions

asked in the Wisconsin CPA examinations over a period of some ten years are collated under each topic and answered. The answers for the most part are brief, sometimes too brief, but to the point. The CPA candidate in that state will probably find that a knowledge of the principles stated will be sufficient for his purposes. Moreover, since the author has indicated the frequency with which questions have been repeated, the candidate can determine which questions are "musts." The case citations appear, however, to be entirely unnecessary. While they lend an air of authority to the answers it can hardly be expected that the candidates will investigate them; nor will the businessman, even if he knows where or how to find them.

It is noted that answers are generally given unqualifiedly. In one case, however, the author has designated an answer as a "Suggested Answer" indicating some doubt in the matter (p. 18). If it was thought that the statute of frauds is not applicable the author should have so stated and shown why.

It appears that several answers are inadequately set forth: Why is Sec. 19 (2) of the Uniform Sales Act cited on a question relating to the transfer of title to goods to be manufactured, and why is delivery or tender of delivery an essential to the transfer of title to future goods? (p. 18). Also, does the signing of a promissory note by an authorized agent always subject the principal to liability on the note? Was it signed in a representative capacity? disclosing the principal? (p. 23). The fact that some issues are deemed collateral to the primary issue should not bar their discussion.

The adequacy of the work for CPA candidates in jurisdictions such as New York is doubted. As has been stated the work comprises some eight topics. It appears that few or no questions have been presented in Wisconsin examinations on Taxation, Bailments, Suretyship and Guaranty, Wills and Estates, Trusts, and Insurance. Examination of questions given in New York over a like period reveals that these topics have been more substantially covered.

ANDREW J. COPPOLA

The School of Business and Civic Administration,
The City College of New York.

**Lasser's Business Tax Guide,**
By J. K. Lasser. SIMON AND SCHUSTER, New York, 1947. 288 pages, $3.00.

This book, the second edition of the Guide, is referred to popularly as the 1948 edition. It is another work from the pen of the widely-known chairman of the Society's Committee on Federal Taxation, who is also a member of the corresponding Committee of the American Institute of Accountants, chairman of the New York University Institute on Federal Taxation, author of *Your Income Tax*, editor of *Handbook of Accounting Methods* and editor of *The Tax Clinic* in *The Journal of Accountancy*.

In the preface Mr. Lasser refers to the work as "a book designed as a practical guide, a check list and stimulus for businessmen—and those who advise business." Although the title does not so indicate, the book is restricted, understandably, to federal taxes. The volume contains a *Guide to Business Taxes* on individuals, partnerships and corporations (43 pages), a *Guide to Business Operation Taxwise* (223 pages) and a *Detailed Index* (7 three-column pages), the latter containing some 1,500 references. For convenience in handling the current edition is bound in hard covers.

Accountants will find convenient the table of cross-references to the Treasury Regulations. Throughout the work are arrows and circles, in heavy print, designating "guides to minimize your taxes in your everyday conduct of your business affairs." The author advises readers to "Check back to these when . . . considering any step out of ordinary business routine."

The work is an interesting and useful compilation. In the reviewer's opinion, however, the experienced accountant and

tax practitioner would have preferred less frequent use in the work of such terms as "tax alternatives," "tax savings," "taxwise business alternatives" and "guides to minimize your taxes."

Leo Rosenblum

The School of Business and Civic Administration,
The City College of New York.

**Montgomery's Federal Taxes — Estates, Trusts and Gifts (1947-48),** by Robert H. Montgomery and James O. Wynn. The Ronald Press Company, New York, 1947. xi+1050 pages. $10.

This volume represents the current annual edition of this standard work, the contents of which are presented in the same pattern as heretofore. As usual, the reliability of the text has been maintained by reason of the inclusion of the additions and revisions made necessary by current decisions and rulings, as well as statutory changes. Particular attention has been paid in this edition to the effect of T. D. 5567,—the Treasury Department's amended regulations for the application of the *Clifford* doctrine.

The carefully planned typographical arrangement of the text makes for easy and ready identification of law, regulations, citations and commentary. The excellent plan of indexing and cross-referencing adds immeasurably to the usefulness and value of the work.

Once again, it is this reviewer's opinion that this book is an indispensable part of the library of all practitioners in the field of fiduciary taxation.

E.S.

**Survey of New York Law**

(1946-1947): Contained in the October, 1947, issue of the New York University Law Quarterly Review. (Volume XXII, Number Four). New York, N. Y.; pp. xliv +432. Two dollars per issue; three dollars per year.

This compilation represents a new type of professional service, undertaken by the faculty of the New York University Law School. Patterned in style after the parent series, *Annual Survey of American Law,* this compendium is based upon New York statutes, decisions, and materials enacted or reported during the fiscal period from June 1, 1946 to May 31, 1947. It should be of great assistance to persons interested in "Keeping up with the Law". It is divided into four parts:

Part One —Public Law: In General

Part Two —Social, Business and Labor Regulation

Part Three—Private Law

Part Four —Adjective Law.

**Case Studies in Auditing Procedure:**

No. 4—A Public Utility (32 pages); No. 5—A Corn Processing Company (64 pages); No. 6—A Management Investment Company of the Open End Type (48 pages).

Prepared by individual members of the Committee on Auditing Procedure of the American Institute of Accountants to illustrate actual applications of auditing procedures. Single copy price —50 cents; 25 per cent discount for quantity orders of 25 or more copies; special price of twenty-five cents per copy to accounting students enrolled in recognized colleges or schools. (Note: If delivery is to be made in New York City, add 2 percent for Sales Tax.)

**Tentative Statement of Auditing Standards**

(Their Generally Accepted Significance and Scope), A Special Report by the Committe on Auditing Procedure of the American Institute of Accountants. New York, 1947. 43 pages, single copy price—50 cents; 25 percent discount for quantity orders of 25 or more copies; special price of twenty-five cents per copy to accounting students enrolled in recognized colleges or schools. (Note: If delivery is to be made in New York City, add 2 percent for Sales Tax.)


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